AN INTRODUCTION TO THE SOCIAL SCIENCES

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PREFACE

Interest in the social sciences has increased tremendously within the past generation Along with this increase has gone such an expansion of knowledge that even the intelligent and interested man has difficulty in grasping the main essentials of the field The work of specialists has provided an amazingly complex set of tools and an abundance of lumber but no common knowledge of how the materials and tools can be combined to make a satisfactory house

College social science departments have grown with public interest They have filled their ranks largely with competent specialists and have encouraged their students to concentrate their work in limited fields The results have in some ways been good, but the student has thereby frequently been denied any adequate survey of the general field of the social sciences For the average undergraduate the social sciences have meant a few unrelated courses which may or may not be fairly representative of the entire field

Chaos in the social sciences has inevitably brought its harbingers of order In some cases the student has been given a single social science course which presents in epitome each subject in turn—a modicum of history, a taste of political science a helping of economics and a pinch of sociology, with possible added sprinklings of geography, biography and other spices Such a course has several difficulties The time for any one subject is so small that it is occupied largely with a few basic definitions The division of subject material is never satisfactory because the departments are not really water tight The fragments of the course tend to be unconnected, particularly because each is taught ordinarily by a specialist without time or interest to fit his section into any general pattern

Dartmouth has been experimenting with the general social science course for something over twenty years Our central concepts have been three (1) That the material be clustered around human institutions such as the family or the state and not around traditional subject materials as history or sociology The family, for example is a natural unit for consideration with ramifications in all social science departments (2) That the institutions be developed as far as possible without consideration for ordinary departmental interests, and arranged according to psychological more than merely to logical considerations Any topic such

as the family has such intimate relations with other topics that dozens of schematic arrangements become possible In this situation the best solution is to arrange topics so that they best engage student interest (3) That instructors should teach throughout the course preferably in small discussion groups A single instructor is much preferred by the average student regardless of the competence of the specialized performers in a variety show

The Dartmouth experience with the general social science course started with a required one semester course for freshmen The success of that experiment led to its expansion when the present social science curriculum was adopted At present Dartmouth requires two years (twelve semester hours) of social science work for all undergraduates A first year course (six hours) is required of all freshmen and is generally historical in approach developing Western civilization from the mid eighteenth century to the present The second year general course is descriptive of current social institutions and their problems it is not compulsory but is particularly recommended for men who do not expect to major in the social sciences For social science majors there is a different type of survey which requires more time and which gives greater technical information in the subject in which the student is to major

The present book is the product of the second year survey course Its writing has been due to a dissatisfaction with the book readings used in the past Only bitter experience can prove the difficulty of obtaining any adequate and readable description of a given social situation in a proper number of pages for a class assignment Even where proper selections were available they were costly to provide, awkward to store and read, and uneven in style content and point of view Such difficulties gradually exhausted our patience and we started to write our own assignments Put into mimeographed form they brought favorable reactions from the students and in consequence we decided that other teachers with similar problems might be benefited if we gave our material wider availability in book form

The work of preparing the book as of designing and giving the course has been cooperative Of the eight participants, seven have been in the course from its start, while three taught in the earlier one semester freshman course The responsibility for specific chapters is indicated in the table of contents

The topics have been picked partly on the basis of their intrinsic importance and partly for their function of including material from the various social sciences Other topics might have been possible and one or more of the present list excluded, but we do feel that the present selection is highly useful The most obvious omission is foreign affairs which for us is covered adequately in the first year course others may desire to find the topic developed elsewhere

The arrangement of the topics has come after considerable experimenta tion and seems both logically and psychologically sound In general the early topics concern economic activity This order indicates not only that we feel economic institutions to be of basic importance but also that an understanding of them is of great importance in the intelligent consider ation of other institutions The survey of governmental functions comes near the end of the book because we feel that democratic government is the meeting place of the tremendous variety of forces which constitute mod ern society and consequently can be understood only as those forces are understood Each topic has been written with sufficient completeness however to permit a different arrangement The emphasis can be changed in numerous cases by omitting one or more chapters or even topics

The present staff presenting the course at Dartmouth is convinced of the desirability of encouraging student discussion of the material—if possible in quite small groups of not over fifteen Such discussion should not be allowed to degenerate into violent debate, for severe clashes of opinion produce but little light

Supplementary reading is of course optional with the instructor Read ing lists are presented by topics rather than by chapters In our own teaching we have also made some considerable use of motion pictures

Finally our appreciation should be expressed to many people Above all we have benefited from the encouragement and facilities given us by President Ernest Martin Hopkins Dean E Gordon Bill and the trustees of the college without their support our work would have been impos sible We are also intensely appreciative of the cooperation given us by the various social science departments of the college and particularly by their chairmen Then too we feel a considerable debt of gratitude to our students who not only have taken the course with apparent pleasure and profit but also have volunteered various suggestions of value The Dartmouth College Library has extended us its unfailing courtesy and helpfulness As to specific books and authors our debt is too various and extensive to permit anything but a general expression of appreciation

ROBERT E RIEGEL
Editor

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PART I

Social Institutions and Social Change

CHAPTER 1

SOCIAL ORGANIZATION

Man and Society

Man is a social animal From the cradle to the grave, his life is determined by the society in which he lives He comes into the world as a naked and helpless animal which is endowed by nature with certain potentialities for becoming a human being Without the constant influence of society however, these biological potentialities for humanity will never be realized As an infant a child an adolescent and an adult man's conduct is molded by influences which are outside the individual These social influences are exerted directly through his parents his brothers and sisters, his childhood playmates, his teachers his religious leaders, his business associates and his adult friends They are exerted indirectly through the books which he occasionally reads, the daily newspapers which he eagerly peruses, the picture magazines which he carefully scans, the motion pictures which he sees and hears the radio programs which he enjoys, and the conversations he overhears wherever he goes These various social influences are the most important factors in the individual s life In strict truth, they *are* his life They constitute the very stuff of which his personality is made Without an intimate and continued contact with other persons, man can never become a human being Society is indispensable to the development and preservation of those traits which distinguish man from the animals

For man is not born human He is born with the physiological potentialities for becoming a human being But if these potentialities are not speedily developed by human contacts the individual remains on a level but little removed from the higher anthropoids This fact has been demonstrated again and again by the discovery of children who have been deprived of human companionship at an early age In certain instances these children have been isolated from all but the most rudimentary human contacts because their parents have wished to conceal their identity or even their very existence In certain other instances native children have wandered away from their villages and have lived for years among the animals of the forest When these children have been discovered after years of isolation from human society they have been more like the beasts with which they have lived than like the human parents who bore them The combination of traits which we call human nature does not

expand like a growing flower from the potentialities inherent in the germ plasm Close and continued contact with other persons is absolutely necessary for the development of human nature Man as we know him is the product of society

The more we understand the processes of human development, therefore, the more we realize the fundamental role which society plays in this development It has been well said that 'the proper study of mankind is man This adage must now necessarily be amended to include the provision that the proper study of man is—the society in which he lives ' It is only by understanding this society—the complex structure of institutions which composes it and the dynamic processes by which these institutions change—that we can begin to understand the curious creature that is man

The Social Group

Man as we have suggested is definitely a social animal This is equivalent to the statement that man is a group animal deriving his social consciousness and his social characteristics from his membership in a wide variety of human groups The group may be defined broadly as two or more persons who are in communication with one another over an appreciable period of time and who have developed a common function or purpose The tendency to unite in groups is perhaps the most important single characteristic of human beings The traits which distinguish man from the animals are all related directly or indirectly, to this gregarious propensity of mankind The groups in which human beings live are found to vary in intimacy and congeniality from the family to the political party from the child s play group to the business association, and from the close friendship of old cronies to the impersonal dealings of buyers and sellers in the market place The important consideration in all of these varied relationships however is the fact that man is constantly in more or less direct contact with his fellows Even when he is physically isolated from human companionship he remains in close touch with other persons and groups through his memories which are themselves social products Each of these group contacts inevitably places its imprint upon the plastic personality of the human being In this way, the human personality is molded like the proverbial clay in the potter's wheel

The group provides the social setting in which each individual lives and has his being Each person has been exposed during his lifetime, to a different combination of group influences This social fact combined with the different hereditary equipment present in the germ plasm of every individual (with the exception of identical twins), explains the wide differences in human personality Nature and nurture collaborate to present a society which is composed of two billion human beings, no two of whom are exactly alike In the pages which follow, we shall describe

the social forces which form this society and place their indelible imprint upon the human beings which compose it

The group setting in which the individual develops takes the form of a variety of reciprocal expectations which the members of the group impose upon one another When one person greets another for example he has learned to expect that the salutation will be returned in the form which has become appropriate to the group setting Members of the same family group learn to anticipate certain definite reciprocal attentions from parents from brothers and sisters and to a lesser degree from the more remote members of the family The expectations entertained by various groups range in importance and complexity from simple matters of etiquette to such fundamental social attitudes as a belief in God in monogamous marriage or in private property Each individual is born into a complex network of such group expectations His informal education is a process by which the mass of expectations of the various groups may be inculcated in him in such a way that he will never forget them or question them The larger society inducts him into membership through the medium of the expectations of group participation

The human being is thus in a sense composed of a number of different fragmentary human beings This cast of characters within the individual is composed of the roles which he plays in the various groups of which he is a member Each group calls out a different set of expectations, which combine to form the definite role which the individual plays We are all familiar with the fact that the individual acts differently in the intimacy of his family circle than he does when he is dining in a restaurant among strangers He is a different person in the classroom than he is at a fraternity dance or at an athletic contest Each role which the individual plays in a different social setting requires a different set of responses and involves a different combination of group expectations The same man may be a tyrant in his office and an exceedingly mild person in the bosom of his family The behavior patterns which the group expects from the individual are clearly different in each case We are all anxious to live up to the expectations which our groups place upon us, to play the role which our group has allotted to us It is only in this way that we can gain the esteem of our fellows Through the expectations which it places upon us the group defines our conduct gives us our standards of right and wrong our values our ideals and our very aspirations

The great majority of persons accept the definitions of their group in all important matters of belief and conduct with little or no doubt and criticism These persons form the great body of social conformists, of solid citizens of average men and women who never deviate in any striking degree from the norms which their society has established In every society, however, there are some persons who either refuse to accept the definitions of the normal group in which they live or who grow up in

contact with anti social groups whose definitions are considered to be outside of the norm of conventional society The criminal is perhaps the most striking example of this deviation from the standard set by society He has rebelled against certain of the traditional definitions of the larger group and has motivated his conduct to conform with the expectations of smaller and anti social criminal groups The total implications of this criminal situation will be clearer when we study these matters in more detail in subsequent chapters We are concerned here with the criminal as an example of one who has refused to play a conventional role in a law abiding society He is the person who deviates deliberately and consistently from normal group behavior by refusing to adapt his conduct to the expectations of society The importance of the group in the life of the individual is indicated as much by a study of such rebels as the criminal as it is by a study of a normal and conventional human being

The Folkways and the Mores

Group expectations determine a large part of the conduct of human beings These expectations are found in such diverse forms as the traditions of family life, the code of honor among thieves the informal regulations which business men place upon their own conduct in the market the ties which hold together the members of a church sect or the loyalty of a student to his college This wide variety of human expectations has interested students of society for generations These customs have received their classic formulation from one of the most profound of these students of society—William Graham Sumner He has divided all human customs into two principal categories which he has called the *folkways* and the *mores* These customs are the products of human activity of group living in a very real sense An understanding of their nature is fundamental to a true appreciation of the causes of human conduct [1]

Folkways are literally the ways of a folk —habits or customs which have arisen in the course of the daily life of the group The folkways arise out of the simple but vitally important fact that human beings must act in order to live Action, in other words is primary both in the animal and the human world Human beings are continually faced with new situations which require definite responses even though they may have no precedent to guide them The form that this action takes is often a random, trial and error attempt to meet a new situation in some more or less satisfactory manner The nature of the folkways may be clarified by taking an imaginary example of the evolution of a single folkway

A savage is faced with the problem of crossing a stream to escape from his enemies or to avail himself of the better hunting facilities on the other side Let us suppose that neither he nor his people have had any

[1] William Graham Sumner *Folkways* (Ginn and Company Boston 1906) Chapter I, Fundamental Notions

previous experience with streams or with the methods of crossing them In desperation he may cast about for a way of meeting this new crisis in his life After several random and completely fruitless attempts he may hit upon the idea of crossing the stream by resting his hands on a dead tree trunk and kicking his feet until he reaches the opposite bank This is clearly not the most efficient method of crossing the stream In the eyes of the group however this is the best method they have ever seen since the situation is unique in their collective experience They have no desire to improve upon this method but are content to repeat the performance in exactly the same way each time they are faced with the problem This technique is followed with scrupulous care by other members of the same tribe who transmit it from one generation to the next This method of locomotion on water becomes in short a folkway of this particular people It becomes the recognized way of meeting this particular situation and is incorporated into the traditions of the people It becomes literally one of the ways of this folk The necessity for action has produced a response which soon becomes the standard and accepted method under the circumstances The folkway is now complete

The folkways of a given people include the tremendous variety of customs which have arisen to meet the different situations in the life of the group Many of these customs are evolved in the same haphazard way that our hypothetical savage learned to cross the river on a log Many another has evolved in a more rational manner to meet some specific situation This situation may then have completely changed but the folkway hangs on a relic of a period when it was useful and modern Men become attached to their folkways and cling to them with a blind tenacity even though they may be demonstrably obsolete Man is a creature of habits and habits die hard

The folkways of any society include thousands of such group habits which have grown up in the life of the people Representative folkways are the rules of eating and drinking salutation and departure the myriad details of dress and the circumstances under which a given article of dress shall be worn the endless but important ceremonies growing up about the general concept of politeness —all these and many more make up the cluster of folkways of our society Some of these folkways are gathered together in the volumes of etiquette Emily Post is thus one of the most famous compilations of folkways in the English language The great majority of the folkways however exist in unwritten and implicit form in the social heritage of the group They form the body of expectations by means of which the group instructs and educates the individual so that he may conform to the common pattern The gradual acquisition of the folkways of the social group is the process whereby the biological individual becomes a human being

The customs which we have called folkways have for the most part

been those which are marginal to the vital welfare of the group It is not a matter of overwhelming importance to the group, for example, if a man fails to remove his hat when addressing a lady He is expected to do so, it is true if he is to conform literally to the dictates of polite society But he is not ordinarily clapped in jail or banished from the country if he fails to carry out this or any other folkway in its literal form The folkways in other words are those group customs which are not considered to be of fundamental importance to the basic welfare of the group as a whole

The mores on the other hand, are precisely those group habits which *are* considered to be fundamentally important to the welfare of the group as a whole The distinction between the folkways and the mores is clearly an arbitrary one Many individual customs are so clearly marginal to the welfare of the group that it is impossible to draw a clear line of demarcation Some distinction however, is drawn between these two types of custom in any society All customs are not held to be equally important to the group Men lay greater stress upon the fulfillment of some group expectations than others They impose more drastic penalties upon the violation of these important expectations A rough distinction is drawn between the folkways and the mores by the members of any society even though the great majority of persons are profoundly ignorant of the existence of the two concepts If such a distinction is actually made in practice, it follows that some knowledge of the basis upon which the distinction is drawn is important to an understanding of that society

The term *mores* is the plural form of the Latin word *mos* which means custom The term mores is also the root of the word moral which therefore literally refers to an act or belief which is customary or habitual An act is moral if it is customary to the group as a whole over an extended period An act is immoral if it departs from the habits of the group The concept of morality is at present largely confined in our society to one particular phase of group custom—that pertaining to sexual relations The term immoral is customarily applied to one who has transgressed the sex mores This is an arbitrary limitation of the concept The judgment of immorality may be applied with equal justification to the violation of the mores in any field of group activity A person may thus be immoral' in his business dealings, in his treatment of his children, in his attitude toward the government or in his callousness towards the unfortunates in society All of these institutions are incrusted in a complex web of the mores, whose infringement endangers the safety of the group to an extent equal to a violation of the sex mores

The process by which folkways become mores is a matter of changing group emphasis and definition The distinction may have evolved slowly and gradually so that a particular act becomes so invested with antiquity that it assumes an importance to the group which is completely out of keeping with its intrinsic importance On the other hand a crisis in the

life of a group may result in a suddenly increased importance attributed to a particular custom The real or supposed welfare of the group is the crucial consideration in any case no matter what the process has been by which this judgment has been reached If a group of persons decides that a particular ceremony is important to their welfare it *is* important to their welfare no matter how ridiculous it may appear to an outsider The group is the last court of appeal for judging the importance of its own customs There is no international supreme court to nullify such group judgments

Representative examples of the mores come readily to mind In our society the customs related to monogamous marriage to the belief and worship of the Christian God to an insistence upon the absolute rights of private property and to a belief and practice of democratic government are among the fundamental clusters of mores Likewise the numerous written and unwritten prohibitions against murder rape incest theft sexual immorality polygamy and the like are further examples of group judgments which have assumed the status of mores These moral judgments are either positive or negative They may be stated either as *thou shall do this* or as *thou shalt not do this* The mores are directed at transgressions of omission as well as at those of commission The individual is constrained by society to play certain roles and to refrain from playing certain other roles He is subject to drastic group reprisal if he fails in either respect As the child participates in the life of the group he learns the positive statements and negative taboos which make up the moral code of the group The mores become an intimate part of his life in the same way that the other group expectations become an integral part of his personality The group thus places its imprint upon him in such a way that he can never escape

We have suggested that there is no intrinsic reason why a particular custom should be a folkway or one of the mores The distinction between the two is largely a matter of group definition of the arbitrary feeling that some action or belief is contrary to the welfare of the group as a whole The same identical act can stand against the mores under certain circumstances and stand in complete accord with them under other circumstances The taking of human life without unusual provocation is under ordinary conditions considered as a serious offense against the mores of any social group In time of war however the same act is considered highly praiseworthy The change has taken place in the social setting and in the group definition The same act is thus alternately considered within and without the pale of ordered society This difference in group definition is even more significant over a long period of time in the life of the group Such varied activities as dueling capital punishment for minor theft witch burning religious torture infanticide and many other forms of violence equally repugnant to modern sensibilities have at one

time or another been definitely prescribed by the mores in our society This moral relativity has been described in the phrase— The mores can make anything right The importance of the social setting and the group definition of behavior needs no clearer or more explicit statement

Laws

A law is a group expectation which has the formal sanction of the state A law is a social product in very much the same sense that the folkways and the mores spring from human activities The individual must direct his attitudes his values and his conduct to accord with the law of the land The social group follows the same general process in defining an activity contrary to the law as it does in the evolution of the folkways and the mores The degree of formality implicit in the law is greater than that of the folkways and the mores and the sanction of society is stated in more categorical terms All of these elements of the group will are pro duced by the social definition of social situations as they arise in the trial and error process of group life Taken in their entirety they consti tute the most formidable combination of factors which determine human conduct

Many of the important laws in our society are mores which have been written down and codified in a formal system These laws have evolved from the mores by a slow and gradual process The English Common Law is one of the most striking examples of this gradual process of social evo lution Certain elements in this body of law are the products of a thousand years of group sanction during which time they have remained unwritten for the most part Many of these age old customs were never incorporated in a formal legal code until they were brought to America by the English settlers and gradually introduced into the statutes of the colonies

The laws which have the implicit sanction of the mores are those deal ing with the fundamental crises of human life—birth death, marriage property the taking of human life and other similarly important aspects of group behavior The majority of such laws would in all probability be obeyed most scrupulously even if they were never formalized in the code The laws against murder, theft, and adultery, for example are merely the crystallization of traditional mores by which the group has long defined these acts as definitely contrary to its welfare Such obvious infractions against the welfare of the group would never be performed by the major ity of persons under any circumstances law or no law These strong moral judgments have existed in one form or another in the mores of the group from time immemorial The formal sanctions which they receive from the state are largely supplementary to their basic function as informal agencies of social control

The same general line of reasoning applies to those laws which run counter to the mores of a particular group Such laws are doomed to com

parative failure or virtual nullification no matter what elaborate means may be employed by the state to enforce them The most important instance of a law which ran directly counter to the mores of a considerable portion of the population was the Prohibition Amendment The use of alcoholic beverages had long held an important place in the values of large groups in the population This acceptance and maintenance of alco hol as a social value was an integral part of their mores The entire police power of the United States Government was unable to enforce an enact ment which lacked the sanction of the mores

All laws are not crystallized and codified mores Such a description applies only to those laws which have to do with such fundamental aspects of group life as we have described above Many phases of the criminal code clearly fall into the category of laws which are closely akin to the mores Many aspects of the civil code however have no such positive or negative sanction in the mores The thousands of statutes in the civil code having to do with the intricacies of modern business for example have no direct basis in the mores Neither do many of the regulations which the modern city places upon the varied activities of its citizens Such laws are the arbitrary decrees through which society attempts to deal with the demands of modern life in a complex and corporate culture The slow and gradual process by which moral judgments are evolved by the group has not had time to work out definitions of much of this confusing and com plicated behavior The problems covered by modern codes furthermore are so involved that simple moral judgments about them cannot be made by the group Many of the contemporary frauds perpetrated by financial manipulations are completely beyond the comprehension of the man in the street They are also largely beyond his moral definition The mores will condemn a man who has stolen a loaf of bread because such an activity has always been within the ken of the rank and file of the group The mores have no such simple and obvious definition to apply to the manipulations of the complex instruments of a credit economy Under such circumstances it is difficult to arouse the moral sentiments of the group even though heavy losses have been suffered by many thousands of persons This gap between the mores and the law will increase as society becomes more and more complex Such a situation will contribute to the general bewilderment of the man in the street His role in the great society will become more and more difficult to understand and to follow

Social Institutions

Social institutions are the most complex units in the social organization We have seen how the necessities of human action have brought about the formation of group responses to various types of recurrent situations These group responses are the folkways the mores and the laws in the approximate order of their increasing formality The social institution is

the final and most complex form in which these group expectations are found The institution is a cluster of conventional beliefs and patterns of behavior of human beings grouped about some central interest Elaborate ceremonies rituals and social structures grow up about these conventional behavior patterns These group expectations and the organization erected to administer them constitute a social institution

The classic definition of the institution has been given by William Graham Sumner who also evolved the fruitful conceptions of the folkways and the mores In his great study of human behavior patterns Sumner has defined an institution as a concept and a structure The essential nature of the institution is summed up in this one simple phrase Subsequent definitions have largely consisted of elaborations of this central theme The *concept* of an institution is in Sumner s words, the idea notion doctrine, interest ' which provides the basic motivating force in its origin and continuation The concepts of certain institutions are clear and explicit The concept of a business institution for example is to make money for the owners Nothing could be simpler or less ambiguous than this The concept of certain other institutions on the other hand is so complicated that it becomes as difficult to formulate as a definition of life itself What for example is the concept of the family? To perpetuate the race rear and educate children to provide a social sanction for sex relationships? The difficulty of stating the concept of this institution becomes clear It is equally clear however that the institution must have *some* concept some guiding purpose some underlying reason for being, some basic social function to perform if it is to survive and flourish from generation to generation

The *structure* of an institution is a framework, or apparatus or perhaps only a number of functionaries set to cooperate in prescribed ways at a certain conjuncture The structure of the institution is the organization by which the concept is realized and carried out Human purposes and human organizations are the two fundamental aspects of the social institution The one is manifestly impossible without the other The one cannot be emphasized to the virtual exclusion of the other if the institution is to maintain itself The institution has a place for the dreamer and the administrator the dreamer to evoke the concept from the experience of the group and the administrator to perfect the apparatus to perpetuate the concept In the process whereby the great institutional structure of Christianity was evolved the role of the dreamer was filled by Jesus and the role of the administrator by St Paul The subsequent history of Christianity has been a process of elaboration upon the work of these two founders

The nature of the social institution may be further clarified by another characteristic example which is close to the experience of every student We refer to the institution of the American college or university The

concept of this institution is the object of considerable controversy among educational theorists but in essence it is to transmit the social heritage from one generation to the next All of the other elements in the concept of the college are subsidiary to this fundamental element of group transmission The institutional *structure* of the college has increased tremendously in size and complexity since the days when Mark Hopkins and his famous log constituted all the machinery that was considered necessary to a complete higher education The structure of the modern institution of higher learning consists of the student body the faculty the administration and the alumni on the human side and the classrooms dormitories laboratories and athletic plant on the material side The human elements in the institutional structure however continue to be the indispensable elements The basic relationship in any institution is the contact of person with person In the educational institution this contact takes the form of student with student faculty with student and student with administration to name but a few of the most common relationships The physical element of the institutional structure is in the last analysis of secondary importance since it merely serves as a framework within which the vital personal relationships take place When the physical and mechanical elements of any institution tend to overshadow its personal aspects the vitality of the institution is seriously impaired

The same general analysis in terms of concept and structure may be applied to any fundamental human institution The concept of the *family* is the production and education of children The structure of this institution assumes different forms in different societies as human groups have evolved characteristic behavior patterns to meet their varying needs The concept of the *state* has been suggested as the preservation of life liberty, and the pursuit of happiness for the maximum number of persons Certain persons would substitute the term property for the last member of this trilogy In any event the institutional structure by means of which this concept may be realized includes the complex organization of the modern state The administrative legislative and judiciary branches of the government the bureaucracy the army and the navy the police force the various properties owned and operated by the state would all be included in the structure of the state The concept of the *church* has been variously defined as the inculcation and maintenance of the spiritual aspects of human life the mediation between man and the supernatural and the preparation of the individual for the life to come The structure of the church comprises the complete hierarchy of religious functionaries from the humble minister or parish priest to the highest dignitaries of the church organization In addition the structure of the church includes the buildings the real estate and the other investments which play an important role in the institutionalization of religion This analysis of the basic social institutions might be continued to include such important institu

tions as those devoted to the production and distribution of economic goods and services recreation health, social welfare social research and the like The institutional point of view however should be essentially clear from this brief analysis Social institutions are human organizations which combine in a unique way the spiritual and the practical elements in human life They form the mechanisms through which the fundamental interests and desires of human beings are brought to a focus

The Functions of Social Institutions

Social institutions play an important role in the organization and preservation of society They arise through the fundamental biological and social urges of human beings They are perpetuated by the same basic forces They offer formal and conventional sanctions for many aspects of behavior which cannot be allowed to operate unchecked and unregulated if the foundations of society are to be maintained Sex behavior for example is regulated by the cluster of mores and institutional patterns grouped about the family These imperious urges are restrained and canalized by the powerful moral sanctions which every society has built about this basic relationship Some such restraints are found in every society on the face of the earth The specific forms which these sexual regulations may take are subject to wide variation The important consideration however is the fact that some such restraint exists and operates in close and reciprocal relationship with the institution of the family Each of the basic social institutions similarly provides that sanction and direction of human conduct without which a stable social organization could never develop We may examine the basic functions of social institutions at greater length

Social institutions are the principal agencies by which the accumulated folkways mores laws traditions techniques and values which make up the social heritage are preserved and transmitted from generation to generation Institutions are the great conserving force in society for they carry on the social heritage through the ages The relative immortality of institutions is an important consideration in estimating the role which they play in the social organization No man can know and certainly no man can preserve for posterity the human wisdom which institutions acquire in the course of their long lives The accumulated traditions of institutions allow each member and functionary of the institution to profit by the experience of the past This function of preservation and transmission of the social wealth of the past is of the utmost importance to society It is most clearly performed by such basic institutions as the family the church and the school

The Catholic Church offers a striking example of this important conservational role of the social institution This venerable organization is one of the most powerful institutions that the world has ever seen The

traditional wisdom of the Church has been handed down in unbroken succession from the early days of the Christian era to the present time As the functionaries of the Church slowly ascend its imposing hierarchy they are gradually given access to all of the profound wisdom which the Church has acquired from its two thousand years of dealing with weak and erring human beings with kings princes rival aristocracies and other similar problems This storehouse of knowledge is unique in human history It indicates clearly the role of transmission which other institutions can only approach An important factor in this preservation of the religious heritage grows out of the vast wealth of the Church in land buildings and investments The material possessions of any institution form a constant nucleus about which the members of that institution can rally in time of need In the two aspects of institutional life—the conceptual and the structural—the Catholic Church has played an important social role in western European civilization

The conservative role of the social institution has certain other important social implications By their very nature, social institutions are extremely resistant to social change This element of conservatism plays a dual role It enables the institution to transmit the social heritage but it also renders the institution extremely suspicious of any important modifications in the social structure Social institutions are inevitably conservative because their power wealth and prestige are based upon society as it is not as it might be after certain changes and reforms have been introduced The more powerful and wealthy a particular institution may be the more content its guiding hierarchy will be with the *status quo* and the more loath they will be to accept any change

Institutions inevitably lag behind less formal elements in society because their power has been erected on the slow traditional accretions of the past Some institutions resist change more tenaciously than others The process by which human behavior patterns are crystallized through the folkways the mores and the laws until they finally become incorporated into institutional form is a slow and gradual one which owes its success to tradition rather than to innovation Institutions are deeply rooted in the contemporary social organization at any time in its history Indeed they *are* that social organization to a considerable degree It would be highly improbable that such vested institutional interests would sponsor any innovation which might directly decrease their own place in the sun

The family, the school, the church and the state are institutions which preserve and transmit the social heritage and are extremely resistant to social change The degree of conservatism of these institutions varies considerably between the broad institutional types and even more between various units of the same type Certain individual churches for example are more resistant to social change than are certain others Certain school

systems are more resistant to educational change than others This situation may result from the fact that the administrative personnels of these school systems are personally more conservative than their fellows in other systems Other educational systems may be more liberal because of similar personnel differences or because the public which supports these institutions demands more drastic social changes Institutions reflect in this way the larger social structure of which they are an integral part No institution can operate on principles which are drastically at variance with the mores of the society from which they draw their support In the final analysis however all institutions must operate in the general direction of conserving the social heritage rather than changing it in any drastic manner The conservative and relatively unchanging interests of human beings which find expression in social institutions render this conservatism inevitable Social institutions welcome change no more than do the average persons who compose them

Social institutions are also important instruments of *social control* By social control we simply mean the restraint which membership and participation in society exert upon the human being This influence of society upon the individual ranges in formality and severity from the simple folkways of family custom to the formal prohibitions of a dictatorial state Social institutions impose definitions of conduct and prescribe patterns of behavior upon the individual They must continue to enforce these definitions of behavior if they are to play an important role in a society of competing institutions

The social control exerted by institutions operates in the following reciprocal manner The functioning institution necessarily prescribes certain forms of belief and conduct for its members stating categorically in the process those forms of which it approves and those forms of which it disapproves Every individual who takes an active part in the institution has a certain role to perform Each of these roles has certain rights and duties which are peculiar to it and to no others As soon as the individual identifies himself with the institution he commences his instruction in the privileges and obligations of his chosen role These traditional patterns form an important part of the accumulated wisdom of the institution The more powerful and venerable the institution may be the more these roles have become encrusted with age and tradition If the individual departs drastically and consistently from the behavior prescribed by his role, the institution has a number of techniques to discipline its recalcitrant member These disciplinary methods range in severity from ridicule and gentle sarcasm through moral suasion to such drastic punishments as excommunication or corporal punishment Such implicit social controls as imitation and public sentiment however are in general more efficient than methods of violence or physical force When

an institution must consistently resort to force on a large scale to maintain internal discipline this in itself is an indication that all is not well with its informal control devices Institutions cannot maintain themselves indefinitely against a large number of their disgruntled constituents by the use of force and force alone If the institutional mores fail machine guns will also fail

A concrete example of institutional controls may be helpful in clarifying this important social function The college is a familiar institution which clearly controls and moulds the conduct of its members This control is not a one sided process Rather is it exerted by all of the members upon one another—by students upon students students upon faculty faculty upon students and administration upon students Each member of the college has a certain role which he is prescribed to follow by virtue of his participation in an educational institution The student plays a definite role toward his fellows toward his teachers and toward the college administration The faculty and the administration have their own reciprocal roles toward the students which they must fulfill as scrupulously as the student fulfills his allotted role Any substantial deviation in the expectations implicit in the student s role toward his fellows his teachers or the administration is dealt with by a number of different control devices He may be ridiculed by his fellows if he departs too far or too consistently from the norm which they have come to expect He may be reprimanded or failed if he departs too drastically from the expectations of the faculty in connection with his class work If he violates the regulations of the college he may be severely reprimanded by the administration placed on probation or separated from the institution

This analysis of the controls of the college might be duplicated and supplemented by an investigation of any of the major social institutions which functions in our society The family the church the public school the business concern and the state each has its own problems of control and its own methods of enforcing its expectations upon its members and upon the persons who come in contact with it The relative importance of the various institutions as instruments of social control varies from time to time For many centuries the Church was the supreme agency of control both in spiritual and in secular affairs The trend of the times at present appears to be a shift toward an increasing centralization of control in the institution of the state The nature of this shift and the corresponding decline in the relative power of other institutions will be evident as we study the concrete details in subsequent chapters

Social institutions form an indispensable foundation upon which all organized societies are erected We shall be concerned below almost exclusively with those social institutions which are found in contemporary

America We shall not attempt to picture the historical growth of these institutions in our own society nor shall we attempt to make a comparative study of such institutions as are found among other peoples at the present time It is important to bear in mind however that the basic forms of these social institutions are not unique to modern American or even to western European civilization These institutions are found in some form in all societies in all parts of the world Social institutions are a universal characteristic of human society

The investigations which the anthropologists have conducted into the lives of primitive peoples have indicated that all peoples possess certain basic institutional similarities The analysis of society which we have briefly outlined in this chapter would apply with equal logic to the inhabitants of the Trobriand Islands or to the peasants of central China All peoples possess folkways, mores customs expectations and social institutions These elements are strikingly different in other societies from those which we respect and obey While institutions in primitive societies do not manifest the elaborate physical structure that our contemporary American institutions have developed, the basic institutional functions are strikingly similar whether we are studying a village in Samoa a settlement of Eskimos or a modern American community

This functional similarity may be illustrated in many ways Primitive man has a definite family institution which carries on many of the functions which we find in our own families The structure of these family groups may vary considerably from our own but the basic functions of reproduction care and rearing of children, the protection of its members against outsiders are all there Primitive man everywhere has developed certain definite religious patterns which perform the same general function as the institutionalized church performs in our society The primitive may worship different Gods with different ceremonies, but the broadly religious function is strikingly similar to our own Education among primitive peoples is largely centered in the family a situation which indeed existed in our own society until the development of the public school system in recent years This educational function in many primitive societies is shared by the elders who are important agencies in transmitting the social heritage from the old generation to the new The educational process is essentially similar, however whether it is carried on in a smoky grass hut or in an air conditioned Gothic recitation hall All peoples have some form of social control which corresponds in function if not in structure to the modern state No people has been discovered in which a state of anarchy may literally be said to exist Government in some form is a universal institution These and other basic institutions are found wherever men have banded together in society Social institutions reflect certain basic needs whose satisfaction is necessary to the life of man in ordered groups

Culture and Social Organization

In order to bring our analysis of social organization to a logical con clusion we need a concept which will include all of the constituent products of human groups which we have considered This all inclusive idea is found in the concept of culture by which we mean all those elements in human experience which are man made as opposed to the biological and geographical elements which are the products of nature In our subsequent discussion of social institutions and social change we shall have occasion to refer again and again to the culture' of the American people to the 'cultural change which is going on at an increasing rate and to the cultural lag which results from this increasing and uneven rate of change It is important therefore that we understand the basic implications of this important and inclusive concept of culture

We have characterized culture briefly in terms of the human products in the environment of man The clearest definition of the concept has been given by E B Tylor in his study of *Primitive Culture* He suggests that culture is that complex whole which includes knowledge be lief art morals law custom and any other capabilities and habits acquired by man as a member of society [2] This definition clearly in cludes all of the products of group life which we have considered in this chapter The folkways mores laws and institutions are all constituent parts of the complex whole' which makes up the culture of a given people Man is the unique culture building animal living together in groups and creating and transmitting culture from one generation to the next The discussion which follows in this book will be concerned with many of the most important aspects of contemporary American culture

This conception of culture employed by the social scientist is widely different from that found in general conversation The average person associates the word culture with symphony concerts modern art and a speaking knowledge of certain foreign languages These and similar intellectual interests are thus popularly associated with the term which is used in this sense to denote a certain superficial polish which can be acquired only by participation in polite society In social science the term is used in a much broader and more inclusive sense to include all of those varied elements in society which have been produced by man We are all, therefore—common laborer and artisan professional man and business executive—equally cultured" in that we all participate in that complex whole which we call American culture By the same token the Eskimo is just as cultured' as the New Yorker for each participates in his own culture to an equal degree For all practical purposes there-fore we are using the term 'culture synonymously with the more familiar term 'civilization" American culture means American civilization—all

[2] E B Tylor *Primitive Culture* (New York 1871) p 1

of the infinite complexity of social habits behavior patterns moral standards business organizations material possessions and legal systems which make up America

The basic elements of culture are of two general types—the *material* and the *non material* The material elements of culture include all those human products which can be directly experienced with the senses—those man made products in other words which can be seen touched heard tasted or felt All of the millions of physical elements which compose the framework of modern society may be considered as material elements of culture Automobile, razors, shoes pencils skyscrapers desks lamps radios—the list could be extended literally to an endless degree The variety of material units in our culture may be partially understood by examining a catalogue of a large mail order house Here are displayed millions of such material elements of the most material culture that the world has ever known

The complex relationships between the elements of material culture are becoming increasingly difficult to grasp and to control Modern man is becoming rapidly submerged beneath the overpowering weight of his own material accumulations The urban individual whose life is increasingly dominated by the machine is particularly conscious of the complexity of this material heritage The whole relationship between man and the machine is essentially a problem of the control of the material culture which is daily becoming more elaborate and more confusing This material heritage, furthermore is changing with bewildering rapidity while the non material controls are correspondingly tardy We shall consider the far flung social implications of this uneven rate of change in a subsequent chapter Suffice it to suggest here that man must direct his best efforts in the direction of changing his non material heritage to keep pace with the inevitable changes in the material elements which are making his life over

The non material elements of culture are clearly the folkways the mores the laws the institutional concepts which we have considered above We have examined these non material elements at such length and at the apparent exclusion of the material elements for two reasons (1) The non material elements form the most important aspect of our culture The content of the social heritage is handed down in the minds of men The intangible elements of ideas form the only permanent basis of culture All the machines in the world would be completely useless if men were suddenly deprived of the techniques and the abilities to use them These techniques and abilities are in the last analysis, non material elements which exist in the form of human ideas and are handed down in the great line of human heritage Similarly the habits the values the expectations the prohibitions the unwritten laws and the mass of traditions which make up the foundation of the social heritage exist in this

same intangible form (2) The material elements in our culture are clearly and obviously the products of human activity and human ingenuity The human source of the material culture appears to the student at first glance No one would be so naive as to suggest that the automobile for example sprang fullblown from the brain of some supernatural power It is clearly the product of a long line of human inventors each of which added something to the completed product It is more difficult on the other hand to appreciate the human source of many of the elements in the non material heritage Customs habits commandments and prohibitions are man made in exactly the same sense as skyscrapers and internal combustion engines Neither the material or the non material aspects of our culture are the direct product of a combination of super natural forces The expectations of the social group which composes our moral code are the products of the way of life of these same groups and of the groups which have come before them The individual must obey these codes if he is to continue as a member in good standing of his particular group or groups Man makes his culture with his mind as well as his hands The world as we know it today is man made For thousands of years man has changed the world Today the world is changing man

CHAPTER 2

SOCIAL CHANGE

The Nature of Social Change

We live in a changing world The group habits, the folkways the mores, the laws and the institutions which we considered briefly in the first chapter are in a constant state of change These elements combine to form the social heritage which is handed from one generation to the next Many of the social problems which confront us at the present time arise from these ever increasing changes in the social heritage The severity of these problems is accentuated by the fact that certain aspects of culture change more rapidly than others and leave the dependent and related elements behind The inevitability of social change and the disparity in the rate of change combine to render the task of social adjustment increasingly difficult An understanding of the process of social change and social maladjustment is essential to an understanding of contemporary social problems In the chapters which follow we shall investigate many of the concrete aspects of social institutions and social problems We shall be concerned in other words with the basic problem of *social institutions in a changing society*

Social change occurs through the introduction of new elements into a society These new elements may be introduced in two general ways—by *invention* taking place within the society or by *borrowing* from other societies All social changes come from a modification or a combination of these two processes By *invention* is meant the process whereby a new cultural element is produced through the combination or rearrangement of previously existing cultural elements in the society This conception of invention is much broader than that ordinarily employed Social inventions are not confined to innovations in mechanical techniques or to modifications of previously existing techniques A social invention refers to *any* new element or combination of elements added to the social heritage from within Social invention thus includes vastly more than those technical innovations which are registered at the patent office Inventions may take place in government, law, education, family relationships recreation or in any of the other institutions and relationships that make up the complex social heritage It follows from this broad cultural conception that the important factor from the point of view of social change is not so much the individual inventor whose name may be attached to

the finished "invention The important consideration is rather the society which provides the elements which are combined to form the invention

Society rather than necessity, is thus the mother of invention No matter how great a necessity for the automobile for example, might have existed in the eighteenth century it would have been impossible to invent it until the other cultural factors were also there No inventive genius no matter how brilliant he may be, could possibly have fabricated all of the elements in the automobile out of his own fertile imagination The social heritage had to be ready for the automobile before it could be 'invented Society provides the elements with which the inventor works as well as the medium in which his inventions will be tested Social change in a variety of forms is the direct result of these innovations in the social heritage The effects of many inventions upon social institutions are often very great and extend into fields which were undreamed of by the original inventor We shall consider in some detail below a few of the many social changes brought about by certain key inventions

Invention is not the only source of social change In a strict sense it is not even the more important source The majority of the elements in the social heritage of any people have been borrowed from the social heritage of other people It is much easier to borrow an idea or a technique than to invent one There is no society on the face of the earth which does not owe the great bulk of its elements to borrowing from other societies The student who stops for a moment to analyze the tremendous variety of elements in our culture—from our family and religious institutions to the way in which we earn our living—will appreciate the relative importance of borrowing in the process of social change It has been stated by close students of comparative societies that not more than 10 or 15% of the traits in any society are independently invented by the members of that society The other 85 or 90% is borrowed from other cultures

When new elements are introduced into any society from without vast and unexpected changes often occur in the social institutions of the recipient culture The changes brought about in many primitive cultures by the firearms and firewater of the white man form some of the most depressing chapters in the history of the western world When the invading culture is backed by the weight of numbers and the physical force which accompanied the white man most native cultures have been unable to withstand these alien elements Under the impact of the overpowering new culture, the native cultures withered and died

The culture of the United States is the most spectacular example of the mingling of different elements that the western world has seen since the days of the Roman Empire Our culture at the present time is a vast mosaic composed of elements from all over the world Our laws our religious beliefs and observances our science and our art are all composed of elements which have come to us in one form or another from

our European heritage The culture of England has been perhaps the strongest single influence in the development of our social heritage Many other nations and peoples however have exerted a profound influence upon the composite and synthetic whole which comprises contemporary American culture Every day of our lives we are influenced directly or indirectly by some cultural element or combination of elements which has entered our social heritage from without The twin processes of invention and diffusion therefore combine to bring about the rapid and ceaseless changes which are apparent in our dynamic society

The Process of Social Change

Social change does not occur in a completely random or haphazard manner The inventions and borrowings introduced into a given society do not affect all of the elements of that society with equal severity or at the same time A definite sequence can be observed running through the apparent chaos of the changing folkways mores laws institutions and techniques of a dynamic society This sequence to be sure is not apparent in every conceivable instance of social change Examples can readily be advanced in which social institutions have followed a different sequence of change or no apparent sequence at all In spite of these admitted exceptions however the general course of social change is approximately as follows

(1) *Social Techniques*—We have spoken of the ways in which a new element or combination of elements is introduced into any given society from within by invention or from without by borrowing A new social technique a new way of doing things is thereby established Such techniques are found in the fields of art literature politics science economic activity or in any other of the important aspects of human activity The social techniques which have exerted the most profound influence upon modern society have probably been those related directly or indirectly to the ways in which men earn their livings Science has directed its amazing powers of research into this field to an increasing extent in the last hundred and fifty years The investigations of both pure and applied science have contributed in a spectacular fashion to the production of economic goods and services Inventions by the million have been made and borrowed in recent years with perhaps the majority of them directed into the broad field of socio economic improvements The complex series of social and economic changes known as the Industrial Revolution was produced in considerable measure by technical inventions It is necessary only to mention the social implications of the cotton gin upon the life of the South the influence of the telegraph upon the distribution and marketing of commodities and securities and the effect of the railroad in the economic development of the nation to understand the influence of technical inventions upon the socio economic life of our society

This emphasis upon the economic processes does not mean that many discoveries in the field of art religion education and politics during this period did not profoundly influence the course of social change Economic techniques should not be emphasized to the exclusion of other factors in the complex process of social evolution The relative importance of the changing methods of production however cannot be underestimated if we are to understand the nature of our contemporary society The thesis is therefore that changes in economic techniques occur first and set in motion changes in related economic institutions whence they are communicated in turn to other elements in the social structure

(2) *Economic Institutions*—The economic institutions and relationships growing out of the underlying technical processes are the next to follow in the course of social change The last century and a half has witnessed improvements in the techniques of manufacturing which have led inevitably to a demand for more capital resources than the individual owner could provide Large scale industry was the natural outgrowth of the improvements in production which accompanied the Industrial Revolution and which gave this period of social change its name Large scale industry in turn could only be realized by the concurrent growth of the corporate form of business organization The elaborate structure of corporate organization which is one of the most important aspects of contemporary society was thus in a sense a product of a number of technological changes in industry

In the course of these economic and social changes the individual manufacturer found increasing difficulty in competing on equal terms with the corporation Production and distribution costs in many industries increased to such an extent that the individual owner found it necessary to call in the public to help him finance his business The increasing rapidity of technological change necessitated an increasing appropriation for research in order to keep up with the newest developments in industry Manufacturing came to be carried on more and more with expensive machinery rather than with hand tools and the smaller corporations stood at a disadvantage against the larger corporations This type of competition in turn led to the elimination of many individuals and small corporations as the more powerful organizations came to dominate the economic field The trend to monopoly became more and more pronounced

The corporation to be sure was a form of business relationship which was invented long before the Industrial Revolution This social change did not call the corporation into being where nothing of the kind had existed before The relative importance of the corporation as a dominating element in economic life however was greatly increased by the necessity for increasing financial resources to carry out the implications of the technological changes during this period Big business became the

rule rather than the exception as more and more industries came to be dominated by a few giant corporations Technology thus produced its first profound changes in the institutions which were directly related to the economic process

(3) *Social Institutions*—Changes in economic institutions are in turn communicated to the other basic social institutions—the state and local government the family, the church and the school The changes brought about in these cultural institutions by the impact of such economic relationships as large scale business organization monopoly concentration of money and credit facilities absentee ownership security and commodity speculation and life insurance are too vast and complex to consider here in any detail These institutions must necessarily adapt themselves to the changing economic structure if they are to survive In this conscious and unconscious process of adaptation the cultural institutions have undergone a drastic series of changes in their concepts and structures In the chapters which follow we shall consider the nature of many of these institutional changes produced by the changing economic structure

(4) *Non Material Elements*—The last elements in society to change are the non material phases of the social heritage—the folkways the mores the myths taboos attitudes values and ideologies These various forms of group expectations play an important role in the determination of human conduct Men cling with great tenacity to their traditional expectations and tend to relinquish them only with extreme reluctance These non material elements tend to change only long after the social techniques the economic institutions and the cultural institutions which have brought them into being Men may cherish their expectations for generations after the original way of life which produced these expectations has disappeared These expectations are suffused with all the hopes and fears with which men look upon the world which is familiar to them as well as the world which they would like to see It is generally much more difficult to change these non material elements in the social heritage than it is to change the material elements These human values and ideals form a definite and intimate part of the living personality of each man and woman who shares them Many of these intangible group expectations are absorbed by the child before he can talk and before his critical faculties have been developed A change in these elements means literally a change in the personality of the individuals involved In our discussion of the various social institutions in subsequent chapters, we shall discover ample evidence of the difficulty of changing these intangible elements Many of the most pressing problems of contemporary society grow out of this tenacious resistance to change in human activities even when the material aspects of the situation have completely changed

The Process of Social Change An Example

The complex process of social change may be further illustrated by the use of a concrete example of the impact of a single important social invention upon a number of economic and social institutions In this connection we shall consider the long series of social changes which followed directly or indirectly upon the invention and mass production of the automobile We shall use as our guide the stages in the process of social change outlined above

(1) *Social Techniques*—The technological changes necessary for the invention and popularization of the automobile took centuries to develop Indeed these inventions might be traced back in a single continuous sequence to the earliest beginnings of human culture The automobile could not have been invented without a knowledge of the wheel and the use of metals to name but two of the many techniques employed in its construction Both of these techniques may be traced back to the dawn of history This combination of technical elements reached a combined state of advancement at approximately the turn of the present century so that the invention of the automobile was the logical result This combination of techniques set in motion a number of complex and related social changes

(2) *Economic Institutions*—The rapid development of the automobile industry brought important changes in its wake New economic organizations and relationships were necessary to satisfy the widespread demand for automobiles which the people of America demanded Among the more important economic changes which accompanied the automobile boom were the impetus given the steel glass and rubber industries the growth of huge industrial centers where millions of persons were employed in the fabrication and sale of automobiles and the demand for labor and for other economic goods and services which originated in these new centers of population Business organization and security speculation also received considerable impetus as the field became increasingly dominated by a few giant competitors with assets of billions of dollars The business and speculative booms of the post war period were produced in considerable part by the rapid growth of the automobile industry Shares of the great automobile companies became speculative favorites on the stock exchanges of the country

(3) *Social Institutions*—The family the church, the school and the state have all undergone important changes in their structure and function with the wide pread use of the automobile These changes have varied in importance and complexity from institution to institution, with certain institutions receiving more direct influence from the automobile than others The decline in attendance at many urban and rural churches, for

example may be traced in part to the automobile This machine has provided transportation facilities for the Sunday outings of millions of persons with the result that the church has been forced to compete with the open road for the attentions of many of its communicants The influence of the automobile upon the relative importance of local government has been a significant factor in the changes which these institutions have undergone in recent years The relative importance of the county and the township has been decreased and that of the central government has correspondingly increased The automobile has widened the horizon of the farmer so that he may now reach the state capital or the nearest large city in considerably less time than he formerly required to reach the county seat Other factors have of course also been at work in this process but the importance of this new form of transportation in bringing about centralization of government should not be overlooked If space permitted similar changes might be traced in the other basic social institutions as the result of the automobile

(4) *Non-Material Elements* —The mores attitudes, and values built up about the basic social institutions have been the last to change as a result of the influence of the automobile Many persons still cling to a belief in the virtues of local government to solve all of the problems of human relationships even though transportation and communication have steadily decreased the relative importance of such forms of government In the field of the sex mores which are closely allied to the institution of the family the automobile has brought about important changes in actual behavior even though the values which society places upon such conduct remain relatively static The automobile has provided a means for social anonymity and sexual intimacy which has brought about many changes in the relationships between the sexes This does not mean that the automobile is the only reason, or even the most important reason for the changes in the sex practices which are going on at the present time The automobile has unquestionably been influential however, in bringing about this changing situation and in setting in motion forces which may ultimately change the attitudes with which people regard deviations from the established mores These intangible elements however, are the last to change in the complex process of social evolution They do change but at a pedestrian pace

The example of the automobile was deliberately taken out of its complex social context for the sake of greater simplicity of treatment This example indicates the process of social change which is going on all the time in a dynamic society The adjustment to this change by individuals groups, and institutions has become increasingly difficult This process of social change entails further complications in the social structure The disparity between the changing institutional practices and the social sanctions growing out of these practices is the cause for much of the

bewilderment and uncertainty in our society We shall point out the precise nature of this bewilderment in more detail in the discussion which follows

Cultural Lag

A changing society is also a maladjusted society Social change brings considerable maladjustment in its wake because of the way in which these changes come The important consideration in this connection is the *variation* in the rate of change between two different but related ele ments of the social heritage The non material elements of culture be come so highly institutionalized that it is very difficult to change them In the process of social change these elements lag behind the material elements The difference in the rate of change between the material and the related non material elements brings about a situation which is called cultural lag Professor William F Ogburn explains this concept as follows The thesis is that the various parts of modern culture are not changing at the same rate some parts are changing much more rapidly than others and that since there is a correlation and interdependence of parts a rapid change in one part of our culture requires readjustments through other changes in the various correlated parts of culture [1] This concept is so important to an understanding of social change and social problems that its implications should be considered in some detail

In his study of cultural lag Professor Ogburn stressed the fact that all of the aspects of a dynamic society do not change at the same rate of speed This disparity is particularly apparent when we consider the ele ments in a single related cluster of culture traits The nature of human nature is such that changes in material culture tend to occur more readily and more rapidly than changes in non material culture Human beings are by no means completely rational animals They do not discard an idea a belief or a prohibition when their reason tells them that it is outmoded by the changing conditions of life They will rather cling to these beliefs and attempt to persuade themselves that the conditions of life have not really changed They will cling to their habits and customs with greater tenacity than they do to the material elements of their cul ture Men are more inclined to adopt a new make of automobile or a new type of safety razor than they are to adopt a new religion, a new form of family life or a new system of government The danger of maladjust ment between the two aspects of culture is particularly evident when they are closely related parts of the same complex A change in the material elements of the complex other things being equal tends to come comparatively quickly and easily A change in the corresponding non material elements on the other hand tends to come more slowly and

[1] William F Ogburn *Social Change* (B W Huebsch Company New York 1922) pp 200 201

reluctantly The two aspects of a given cluster of traits are thus literally in a continuous state of maladjustment The lag which exists between them may cause many serious social problems

A number of qualifications of this concept as it has been thus briefly stated have been suggested Some critics have pointed out for example that in certain instances the non material element in a related group of traits appears to have changed before the material element thus reversing the order suggested in the hypothesis The belief in Christianity they suggest is certainly a non material aspect of culture The introduction of this element into European life brought in its wake incalculable changes in the material way of life of that turbulent continent Other persons suggest that the two aspects of a given complex may change simultaneously with little or no lag resulting Such a simultaneous change is theoretically possible, but in actual practice it is evident that the material aspect generally changes before the non material even though the difference in time may be comparatively slight Still others have maintained the related thesis that ideas rule the actions of men and that these ideas produce changes in the material aspects of culture, rather than vice versa Many of these qualifications are essentially valid in explaining certain notable exceptions to the general order of social change In spite of these admitted exceptions however the concept of cultural lag remains a valuable tool for understanding the process of social change

Cultural Lag An Example

The student of social problems has only to look about him to find many examples of cultural lag We shall consider the changes which have taken place in the economic independence of the average American and the comparative lack of change which has taken place in his attitude toward his economic independence We refer in this connection specifically to the widespread belief that every man has an equal opportunity to rise to the economic heights provided he works hard saves his money and observes the other traditional American virtues According to this belief unemployment is the fault of the unemployed and if a man has sufficient ability and initiative he can always find a job no matter what the business conditions may be The belief further contains the implicit assumption that there are no social and economic divisions in America and that every man is as good as every other It finally contains a strong suspicion of governmental interference in business enterprise under the tacit assumption that every individual can take care of himself in a struggle between equal competing units In short, the idea is of a strong, individualistic, self sufficient pioneer America

The concept of a lag between two related aspects of a culture implies that at one time these elements were more or less in harmony with one another This harmony was presumably shaken as the material elements

began to change leaving the attitudes and beliefs behind The elements of this American ideal and the related economic situation of the mass of the American people were at one time in a state of relative harmony Men believed in the idea because the way was then open for them to realize it This belief was a product of a way of life in which every man was to a considerable extent actually his own master and was equal to every other man in economic and social status This way of life existed, for all practical purposes in the early decades of the last century These were the days of Jefferson and Jackson when frontier democracy and economic individualism were enthroned in the hearts and the minds of all men The majority of men in these days drew their livelihood directly from the soil or were engaged in providing goods and services to the agricultural population Business and manufacturing were conducted in comparatively small units The possibilities for any man to prosper as a result of his own unaided efforts were practically unlimited Many men of this and later periods actually did make fortunes as America expanded and prospered Government in these pioneer days was considered a neces sary evil, a sort of policeman whose powers should be kept at a minimum The frontier stretched away invitingly as far as the eye or the mind could reach

Under such a favorable combination of circumstances it is natural that social attitudes should arise which placed a premium upon the efforts and abilities of every man to gain his fortune in any way he so desired, without let or hindrance from his fellows or from the state The material and the non material elements—the way of life and the attitudes which interpreted and justified this way of life—corresponded very closely for a brief period This fortunate equilibrium between the actuality and the ideal was by its very nature a transitory relationship Changes in the material field appeared with increasing rapidity and the related attitudes and ideals were left far behind Men thus continued to think and act in terms of a way of life which no longer existed They clung to beliefs which were no longer applicable to the new situation They rested their hopes upon conditions which were continually growing more remote from the changing scene

The social implications of these changes in productive techniques and business organization have been suggested above They will be discussed in considerable detail in subsequent chapters Suffice it to point out here that the increased importance of large scale production the gradual elim ination of thousands of small business units and of many independently employed business or professional men has brought about many funda mental changes in the economic and social structure of America The effects of these social and economic changes upon the institutional life of the people are profound The family the church the school and the state have all been influenced by these modifications in the process of pro

duction and distribution In pite of these manifold changes in the material foundations of society however, the ideal still prevails in the hearts and the minds of a large section of the population The hope and belief that someday somehow each man may make a fortune even in the face of the tremendous concentration of resources in large scale industry—this idea refuses to die There was once a close correspondence between this idea and the reality of economic independence This correspondence has been lessened by the growth of business and industry The idea lingers on

The concept of cultural lag will be further illustrated in the concrete descriptive material which comprises the bulk of our discussion Social attitudes in the fields of industry the family politics religion education social welfare, recreation and many other important institutions change much more slowly than the material realities of these institutions In almost every field of social problems this characteristic of social change will be evident The changing functions of government for example are obscured by the fact that the material situation changes more rapidly than the governmental framework which controls it The enforcement of the criminal law and the rehabilitation of the criminal are rendered more difficult by the presence of obsolete laws and even more obsolete attitudes of criminal conduct and criminal responsibility It is not idle talk to say that man is governed by dead men s bones The tenacity with which men hold to the old ways of thought and belief in the face of a changing social order is amply illustrated on every side in our dynamic society

Social Change and Social Problems

Society is dynamic Our world is a changing world Social change sometimes takes place very slowly sometimes very rapidly Certain elements in our society are in a constant state of flux while certain other elements move with the slowness of a glacier The differential rates of these social changes bring about certain maladjustments in society These maladjustments assume a number of different forms and represent varying elements of danger to the social structure as a whole These maladjustments arising from social change are known as social problems They are the price which we must pay for rapid and dynamic social change Stable societies remain free from many of the maladjustments which must be faced in a dynamic society Such stable societies do not have social problems in the same acute form as may be found in our society These stable societies may be isolated backward degraded and primitive but this situation is not recognized as a social problem by the people comprising such societies Social conditions among these peoples are not viewed with alarm by moralists and evangelists from within their own numbers Their culture is all of one piece as it were with a place for everything and everything in its place Cultural lag and social maladjustments do not exist at

least to the degree that they are encountered in a rapidly changing society Only the dynamic society has social problems in its own eyes

This book is concerned with social institutions in a changing society Some of these institutions are closely adjusted to the other institutions making up the society and others are not Social maladjustment and social problems are strikingly evident in some institutions and are not important in others Some of these maladjustments are considered by the average person to be inescapable and in the nature of things Others are almost universally considered as crying abuses by the great majority of persons although there is often considerable disagreement as to the proper methods of remedying them Some of these social problems are considered to be within the province of government and the people turn to the various political institutions for relief Others are believed to fall outside of the jurisdiction of the state Remedies must be sought for these problems by private persons and private agencies or not at all We do not propose any easy solutions to the majority of these problems We shall point out in certain cases the efforts that are being made by private persons and by government to remedy some of these maladjustments Our primary purpose however is to present a brief but substantially accurate picture of the workings of these institutions in a dynamic society

The institutions whose changes we shall consider in some detail are *first* the basic economic institutions whose influence upon the whole of society is so pervasive and so profound *second* the political institutions which serve to direct and control the economic structure in the interest of the general welfare *third* such broad cultural institutions as the family the church and the school Of these cultural institutions the family will be considered in some detail since it is influenced on the one hand by the economic and political structure of the country and since it in turn exerts so profound an influence upon the personality of the individual Considerable attention will also be directed to such problems as crime race prejudice the plight of the consumer and population We shall attempt to discover the way in which these institutions function and problems arise in a rapidly changing society

This does not imply that the emphasis will necessarily be placed upon the pathological or maladjusted aspects of our changing society Many of these institutions function with comparative efficiency and the persons who belong to them lead normal and harmonious lives Such institutions and such persons do not constitute serious social problems but they are nevertheless legitimate subjects for an introduction to the social sciences The processes of social change may be considered as either desirable or undesirable depending upon the point of view of the observer In the discussion which follows an attempt is made to point out as concretely as possible the fact that this social change is taking place Emphasis is placed upon the way in which these institutions function in their changing

social setting not necessarily upon their pathological aspects The family will be considered for example as a functioning institution in the larger social setting The subject of family disorganization and divorce will be considered but they will be considered in their proper relationship to the total function of the institution In the same way we shall attempt to present a balanced picture of the other important social institutions

Social change is taking place whether we like it or not Certain persons tend to deplore these changes and glance longingly back to a time when our society was comparatively stable when social change was taking place so slowly that the material and the non material aspects were in relatively close adjustment In these happy days of comparative social stability there were few social problems which demanded immediate solutions The organization of the family was stable and secure business and industry were small the average craftsman would find work when ever he wanted it, the crime rate was low, the central government was limited to relatively well defined powers, the church was a vital and powerful organization In retrospect at least, all seemed relatively right with the world This is the point of view of the persons who look to the past for social guidance and peace of mind But those days are gone forever Social change has replaced social stability family disorganization is increasing business is becoming increasingly corporate controlled mil lions of men are unable to find work the crime rate is comparatively high the functions of the central government are increasing and the church has lost its hold upon millions of men and women The old order is fast changing, giving place to the new

PART II

Business Organization

CHAPTER 3

BUSINESS BECOMES LARGE

The United States has emphasized the business of making a living more than has any other nation This stress on material wealth was at one time a vital necessity if everyone were to stay alive During the colonial period there was but a handful of people on the fringes of an unexploited continent The wilderness that stretched for unknown distances to the west offered none of the usual trappings of white civilization except as they were produced from day to day Food must be raised clothes manufactured homes erected schools and churches established government instituted Always the fear of starvation acted as a spur while at the same time the lure of all the good things of life acted as the lump of sugar before the horse s nose

As American civilization developed the economic motivation continued to remain important partly because so many of the desirable things of life remained to be attained partly because the opportunities were so great and partly because economic gain was the most obvious means of achieving importance in the young nation The most obvious advantage of wealth was in its ability to demand the goods that made life more easy and more luxurious but even in the early days there was a definite limit to the advantages of wealth from this point of view Clothes and food horses and carriages houses and servants could not be consumed pleasurably in infinite amounts The ultimate advantages of large accumulations of wealth were in the resulting power and prestige that the young society did not furnish by other means A fleet of a hundred ships the employment of a thousand fur traders or the ownership of an important bank gave its possessor control of the lives and fortunes of many men and made him a power in the councils of the republic He was viewed with respect by his fellow citizens for had he not been preeminently successful in the universal competition for wealth? Was he not better than his fellow men and therefore worthy of admiration?

The claim that the rich are preeminently intelligent and diligent was more supportable in 1800 than today, since there was a greater equality of background and of opportunity One farmer s son had about the same education and about the same opportunity for economic success as another farmer s son while at the present time the possession of wealth may be due at least in part to the accidents of birth and training Even in that day however accusations were heard that the economically

successful were not more intelligent and industrious than their fellows but only more cruel and immoral, and that society was rewarding its least desirable elements

The greatest regard for economic success came during the late nineteenth and early twentieth centuries The exploitation of the country was attaining a climax Large fortunes were becoming increasingly frequent The tycoons of business were widely respected and copied Rockefeller Harriman Morgan, Gould Fisk Armour and Carnegie epitomized the highest rewards toward which the poor boy might aspire Here were men with not only all the purchasing power of which anyone could dream and new ways of spending money were appearing daily but also with tremendous power and prestige in the nation Their industrial empires had practically life and death control over hundreds of thousands of men women and children, while their domain extended to schools churches hospitals libraries and even to the government One of their number Mark Hanna was more than a little responsible for the election of a president of the United States

The importance of great wealth has tended to decline in the public estimation during the past generation even though it is still great Young men have been increasingly attracted to the satisfactions and security and prestige of occupations which do not ordinarily produce large economic rewards Politicians have discovered that money and reelection are not necessarily synonymous terms and that economically poorer groups are well worth cultivating The business success story magazine has given way to the movie magazine—a different kind of hero worship and Horatio Alger has been superseded by the airplane adventure story The president of Harvard or Yale can meet the president of General Motors or United States Steel as an equal regardless of salaries while an Einstein need hardly look up to a Ford

Making Money Wholesale

The popular acclaim traditionally given to wealth assured American society that the able and ambitious boys would try in large numbers to attain financial success The result was that particular occupations were badly hurt since they could no longer attract any large proportion of the ambitious In particular the farm lost its appeal, for farming was clearly one industry in which the attaining of a fortune no matter by ability and hard labor was extremely unlikely the one possibility lay in land ownership particularly of land which might be in demand for the expansion of some city Professions such as the ministry and teaching were in poor repute— those who can, do and those who can t, teach' Doctors concentrated in the cities where they could command the large fees of the specialist and lawyers stressed corporation law All through society people were clamoring for the jobs that produced the greatest

returns in dollars and cents Unfortunately society gave little attention to the way wealth was obtained—the end seemed to justify the means Whether the newly rich had made excellent automobiles or harmful patent medicines, had sold government bonds or building lots that were under water was of minor importance Naturally with such a standard many men sought wealth in ways which a later generation would call undesirable

Early American fortunes were achieved largely from trading whereas more recent fortunes have been obtained mainly in manufacturing transportation and banking, of which this chapter will consider the first with only casual references to the other two The reasons for this change are probably obvious Not until after the industrial revolution was manufacturing taken out of the home steam transportation introduced and the demand for large amounts of capital great Only with large scale commercial production was it possible for considerable numbers of people to amass large fortunes

Throughout the nineteenth century the normal hope of the dollar chasing youth was to establish a business of his own and make it prosperous He felt that working for some one else was slightly demeaning to an ambitious and independent American This ideal implied that there would be hundreds of small businesses in every field each competing strenuously with the others Most people assumed that only with such competition could the consumer be assured of obtaining a good product at a low price and this idea still continues in the minds of many people

Factories Grow Larger

Manufacturers have always accepted the current theory of free competition, but in practice they have found that the search for profits—presumably the proper end for a business man—sometimes leads to a limitation of the free competition in which they believe For any manufacturer to become rich he must build larger and larger factories and sell a larger and larger proportion of his commodity If he is really successful he will tend to dominate his field which lessens or ends free competition

The first step toward larger profits was to increase the size of individual factories, and this process was particularly evident during the second half of the nineteenth century By 1923 the United States had 200 000 factories, while 90% of them had less than 100 workers apiece the 963 which had over 1 000 workers apiece hired a quarter of the total manpower The large factory seemed to have attained a position of dominance

The expansion in size of individual factories has been due to a variety of causes both technical and operating Considerable credit can be given to the most important single invention of the industrial revolution the steam engine Steam can be used more efficiently in a large than in a

small plant In addition it can be used more economically with continuous production than if there are numerous breaks in operation and this fact has been important in factory management since it was easier and more profitable to adjust the men to the machinery rather than the other way around Within recent years the increasing use of electric power has begun to change these conditions

Along with the use of mechanical power has come the development of mass production devices which are more effective in a large than in a small plant Machinery has increased in amount and become more specialized in its work replacing the men who may get tired or ill or make mistakes A single purpose machine is more efficient than a multiple purpose machine provided that there is sufficient work to keep it busy and this latter condition can obtain only in a large plant With machine specialization has gone the specialization of labor since the tightening of a single bolt as a life occupation is more efficient than a more varied occupation Incidentally this specialization of labor was applied to such industries as pork packing and pin making long before they were mechanized machine production has merely made such specialization more usual

The large factory with its great use of machines and its specialization of labor makes more possible the standardization of a product and its parts so that a part from any one of a million automobiles can be used in any other of the million The final evidence of standardization and subdivision is the assembly line in which hundreds of identical parts arrive in almost miraculous fashion in the right number and at the right place to make the final product in one continuous stream

Mass production has been developed primarily to produce an increased profit for the manufacturer and its value for the consumer and for labor has been questioned For the consumer it should mean lower prices if production can be kept continuous but in particular situations the costs of distribution may exceed the savings in production distribution becomes costly as a permanently large market is necessary As to quality the benefit to the consumer is still more doubtful Machinery can produce a fine product if the materials are good but it can also handle more shoddy material than can be worked by hand and produce a product which the ordinary consumer can not distinguish from better grades A heavily leaded silk skirt may look and feel the same as a good skirt until the first laundering removes the filling and leaves but a fine web of weak threads Consequently the continued popularity of tailor made clothes and shoes, and of furniture produced individually by master craftsmen Also the very standardization that is so necessary for mass production appears as a disadvantage to many Every Chevrolet looks like every other Chevrolet —an unhappy situation for some people even though otherwise they might have no automobile at all

Mass Production and Labor

The desirability of mass production from the standpoint of labor has also been questioned Increased use of machinery has lessened the proportion of skilled workmen since the greatest single reason for introducing machinery is to decrease labor costs by permitting one relatively unskilled man to do the work formerly done by a squad of skilled artisans The result is a larger proportion of the unskilled but also a small group of very highly skilled technicians to plan and repair the machines—a group more highly skilled than were their predecessors

The increase of the unskilled tends to decrease the importance of any single workman since a replacement can easily be hired from the ranks of the unemployed and given the necessary training in a short time From the standpoint of labor organization this development increases the importance of the industrial union since the joint action of the entire plant is necessary if any important effect is to be realized

Where labor has lost in skill it has profited from better wages and improved working conditions Cheaper production has produced a greater quantity of goods to distribute and some share of this increase has gone to labor in the form of higher wages or lower prices or both The modern workman—if he is employed—lives much better than did his more highly skilled predecessor of a century ago

Many observers of a past generation have been disturbed by the effects of monotony on the worker They insisted that an occupation such as tending an automatic drill was deadening to the mind of the operator and gave him no joy of accomplishment—not only did he fail to make any complete article of his own but in many cases he did not know the relation of the part on which he was working to the final product while sometimes he had never even seen the final product

This fear of the effects of monotony has lost force within recent years largely because the workmen themselves are not disturbed Truly a man need not devote his entire mind to his job but this condition merely allows him to engage in the much more interesting activity of day dreaming while his increased leisure and higher pay enable him to make many of his dreams come true Now and then a man is temperamentally unfitted for a repetitive job but apparently such cases are comparatively rare Society may worry about the effects of such work on its members but the victim himself is not disturbed Possibly the day will come when all simple repetitive jobs will be eliminated and only highly skilled jobs remain for if a job is simple and repetitive surely a machine can be devised for doing it

Assuming for the moment that from the standpoint of both employer and employee the mechanical nature of modern machine industry is not objectionable then the real problem is to make the work as simple and as profitable as possible Any improvement in efficiency will mean that

there is more product to be divided among those who are responsible for it This is the point of view of the better of the so called efficiency engineers They feel that by making the plant as well run as possible that the work should be easier and the profits greater and that such improvement is primarily the responsibility of the management Starting with Frederick W Taylor at the Midvale Steel plant of Philadelphia they have made detailed studies of each job so that it can be done the most easily and rapidly have tried to select workmen according to the work to be done and have replanned factories to make possible the most effective routing of orders

Factory efficiency seems an obvious advantage to everyone concerned and yet it has frequently aroused labor resentment and opposition, either because it was not properly explained or because it has meant nothing further than a speeding up of the workers An efficiency system which has no basis except that each employee does twice as much work as before is no efficiency at all A proper plan should mean easier work and higher pay and it is from this angle that various unions have become interested There is no reason why efficiency should not be as much to the advantage of the workman and of the union as it is to the employer

Further Advantages of the Large Plant

Operating advantages of the large plant over the small are not confined to the technical points that have been raised so far Purchases in car load or larger amounts are cheaper per unit than smaller purchases while in many cases it becomes profitable for the larger concern to manufacture its own parts and supplies Production can more easily be diversified as for example when the maker of shirts adds collars and underwear to his line By products can be utilized Research and experimentation can be encouraged at a smaller cost per unit of output Also the larger plant can better forecast demand—not only because it can afford more expensive personnel to do the forecasting, but because it produces a greater share of its particular product and hence is not subject to all of the vicissitudes of the small producer

The large concern also has special advantages in the marketing of its products Dealing in larger units its shipping costs are lower Advertising can be greater than that of the smaller firm and still represent a lower unit cost, and the same situation exists in relation to a sales force Exclusive distributing and selling agencies are possible All of which means that the trademarks and the good will of the public increase in value

In management the large concern can afford more money for its top executives because such expense is spread over a greater number of units of production In fact most overhead expenses become somewhat less proportionately while at the same time a proper cost accounting system becomes possible These advantages are somewhat offset however by the

tendency for overhead costs such as salaries of executives taxes and depreciation to remain high during a period of depression

Financially the large company has more resources than the small It can borrow more cheaply either at the bank or by issuing its own securities With larger operations and better distribution there is somewhat less risk of the kind of sudden fall of orders that might produce bankruptcy Greater resources provide assurance for surviving a depression

Businesses That Do Not Grow

Not even the ablest managers can make certain businesses increase in size even in the field of manufacturing Sometimes the total possible demand is insufficient to make mass production economically possible Steam yachts hardly clamor for an assembly line Tailored clothes custom made shoes and works of art fill such diverse demands that the specialization of labor, interchangeable parts and the other characteristics of modern high speed production are hardly practicable In other cases the difficulties of transportation keep the market local as with tombstones In still other cases as women's clothes the large plant has little advantage over the small because it affords no greater opportunity to subdivide labor or use specialized machinery Very considerable segments of business are therefore not at present eligible for mass production and there is no known reason why these conditions will change Even in manufacturing there are practical limits to the size of individual units while agriculture the professions and many distributive functions are even less eligible for mass treatment

The usual assumption that the larger the factory the cheaper the cost of production per unit is not justified in many cases The man who visualizes a future in which all American hats are made in a single factory all artificial legs in another factory and so on throughout the entire gamut of products is far from the truth Every industry has some limits to the practical size of a single factory beyond this point efficiency suffers There are clearly limits beyond which jobs can not be further specialized and machines subdivided in their labors The women s garment industry mentioned earlier keeps the small shop largely because there is little added efficiency inherent in greater size The sewing machine driven by electricity is not made more efficient by companionship Geographical position in relation to raw materials, markets and labor may be much more important than great size

Technical limitations to the increase in the size of factories is not the complete story As a plant or industry grows larger it may well arrive at the point where people get in each other s way—where each man slides from under any decision and passes the buck —where each order passes through a multitude of hands to the utter destruction of efficiency and even of common sense Such an overgrown industry tends to become more and more conservative The risk to vested interests of any possible change

is too great to be taken Carnegie has been quoted as saying that Pioneer ing don t pay while the United States Steel Corporation has been accused of having the policy of No inventions no innovations Regardless of the truth of these specific accusations the fact remains that size may be too great for the efficiency of the industry concerned

In all probability we have ended the era of the rapid expansion of individual plants There is every reason to believe that the present generation has seen but little expansion of plant size and that the future will also witness little of such development except in the case of a few young industries such as aviation There is some basis for the belief that with the increasing use of electricity that the trend may be the other way and that manufacturers will find it desirable to break their operations into small segments locating each segment in a small city

Is Industry Now Efficient?

The increase of factory size with its implications of mass production immediately raises the question as to whether industry as a whole has actually become more efficient—and particularly whether it has attained anything near maximum production The answer to any such questions must be somewhat speculative but there is some evidence that can be adduced on the subject

As tested by the amount of production, manufacturing has apparently been becoming more efficient Since 1875 industrial production has increased more rapidly than the population, while agricultural production has increased at almost the same rate since the demand for agricultural products is relatively stable Estimates for the period of 1900 to 1935 vary between 200% and 500% in non agricultural production while the population increased about 50% One must remember however that during this period there was a tendency of population to move from country to city so that at least part of the manufacturing increase should be credited to an increased labor supply rather than to efficiency The greatest single year of American production (late 1920s) saw a national income of some $90 billion which then fell because of both less production and price changes to some $39 billion in 1932

The growth of American production during the late nineteenth and early twentieth centuries came in the face of a rather rapid decrease in the average hours of labor Presumably increasing efficiency more than compensated for less time spent at work

Even in our most productive years there have been considerable amounts of avoidable waste—that is of goods not produced because of various failures in efficiency Estimates for these years range generally from about ten to fifty per cent Such estimates are made on the basis of the best current practices, assuming that the plant equipment and labor force would remain as it is A fairly conservative generalization is that our

greatest production which came in 1929 could have been increased some 20% by the more general use of known practices tending toward greater efficiency There is general agreement among expert investigators that the existing waste is due primarily to defects in management and not in labor

The above estimates of industrial inefficiency are as moderate as can be made In all probability the better selection and training of labor the modernization of plants the introduction of new machinery and similar changes would increase production much more than the estimated 20% Technical possibilities for the future may be almost boundless

One big factor in lessening the efficiency of production is depressions either local or general Not only is production lessened during the depres sion but skills are lost more or less permanently Unemployment ranged fairly steadily in the neighborhood of 2 000 000 even during the 1920s and reached astronomical proportions after 1929 with consequent staggering losses in production The troubles of the period were undoubtedly empha sized by the very existence of specialized mass production Industries were closely dependent on one another so that the failure of one brought the failure of others in ever widening circles No greater contribution could be made toward increasing the amount of our industrial output than the elimination or at least the lessening of cyclical fluctuations of business activity

Figures concerning productive efficiency also pay no attention to the desirability of the goods produced From the economic standpoint there is no statistical difference between the output of a factory producing a thousand dollars worth of wholesome bread and the output of another factory with an equal value of tainted sausage or poisonous patent medicine Some considerable but undetermined portion of our production consists of products that either add no desirable values to our lives or are positively disadvantageous

The usual justification for traffic in articles generally considered useless or bad is that people want them and pay for them—therefore such people are deluding themselves into the belief that in some way they are benefiting which in itself is a benefit For example a man may buy and consume a bottle of patent medicine in the delusion that he will be cured of tubercu losis He is buying a psychological feeling of hopefulness which compen sates at least in part for his failure to take measures which might really prolong his life Whether his action should be encouraged is a fine problem in human motivation and values, but certainly from the standpoint of society as a whole there is a net loss The purchaser will increasingly be a social liability when prompt treatment might have affected a cure

While most people will agree that various products represent illth rather than wealth there is a profound disagreement as to which is which How does one classify whiskey cosmetics patent medicines open toed shoes, derby hats or rapid changes in style? The verdict depends on the

feelings and sentiments of the classifier And yet practically everyone will agree that much of our production is useless or worse and the great majority will agree that certain specific products should be kept off the market To many of us the making of useless gadgets for the uninformed or psychopathic seems a perversion of the proper uses of an economic system

Closely allied to the production of unnecessary and undesirable com modities is the increasing proportion of manpower that is devoted to the transportation and marketing of commodities rather than to their produc tion Part of this change has been inevitable as small local businesses are replaced by larger concerns with wider sources of raw materials and of markets manufacturing efficiencies more than offset increased costs of marketing Part of the change however probably represents inefficiency including excessive competition Between 1919 and 1927 the total working population increased some 5 000,000 but the number of men engaged in mining manufacturing, rail transportation and agriculture decreased about 2 000 000 (8%) This way of stating the situation is somewhat misleading however since the decline is due rather heavily to the change in agriculture More detailed figures appear in the following table

% of Gainfully Employed in	*1870*	*1930*
Agriculture	52 8%	21 3%
Mining	1 5	2 0
Manufacturing	22 0	28 6
Trade and Transportation	9 1	20 7
Clerical Service	1 7	8 2
Domestic and Personal Service	9 6	11 3
Public Service	6	1 4
Professional Service	2 7	6 5

Quite clearly the service and distribution part of the working population has increased more rapidly than has the primary production sector Equally obvious is the proposition that there can be no increased amount of goods to be distributed until after it has been produced One gets the feeling that we are working harder and harder to sell less and less which of course is an exaggeration However we certainly can not all make our livings by selling each other life insurance The moral seems to be that in all probability our system of distribution has grown topheavy and unduly costly Presumably what we need much worse than increased efficiency in production is decreased costs of distribution

Concentration Goes Further

While the growth in size of individual plants is not at present important there are other more recent ways in which increases of size have occurred Men have continued to desire ever larger holdings and power, but instead

of enlarging individual plants they have added other units In many cases they have added plant after plant company after company until they controlled their own fields and expanded into others

The company that expands widely is fulfilling to some extent a desire for improved operating efficiency even though that aim is probably the least important The concern with numerous factories can specialize its factories in the same way that a smaller company specializes its individual workmen The various plants can be located strategically throughout the country to avoid many of the freight charges of the single plant Business may be so arranged that the great majority of the plants are run continuously on full time thus maintaining the efficiency of their laboring forces while the fluctuations of the business are concentrated in a single plant which operates on full time only when business is unusually good

Other technical advantages are possible for the larger organization There may be benefits in advertising selling forces the utilization of byproducts obtaining capital, buying raw materials hiring labor forecasting market conditions and similar activities One should always remember however that efficiency does not increase indefinitely with size The point will come in time in any industry and fairly soon in many when further expansions produce decreases of operating efficiency

Among the activities of the larger enterprise are experimenting and research Modern inventions are increasingly the products of the large commercial laboratory such as that of the American Telephone and Telegraph Company or of General Electric Trade associations are also important in this connection—as for example the American Gas Association the American Petroleum Institute and the National Fire Protection Association (Underwriters Laboratories) The only important competition to these commercial ventures are the large educational laboratories This situation has raised some questions about the desirability of our present patent laws which were designed to protect individual inventors

The formation of the large business organization is probably less due to the desire to increase efficiency in the ways indicated above than to the desire to control a larger and larger share of the production of a single article so that its price may also be controlled The final goal would be a complete monopoly of that product—a goal which is seldom reached in practice The effects of a restricted number of units or complete monopoly on price will be discussed in a later chapter but several implications may be suggested here The smaller the number of units the more that any one of them can control price even though that control is not absolute or final On the other hand there is little reason to think that the number of outright monopolies has increased notably during the past generation, and even most monopolies can not charge any price they may desire since ordinarily people have at least a poor alternative or can go without

An additional reason for the formation of larger and larger companies

is the desire of the originators for the promoter s profits that are always present A merger or consolidation may of course be created by men who are primarily interested in the operating profits of that business but it may be sponsored by bankers or other promoters who are interested only in the profits of promotion Many of our larger companies have been engineered by bankers who are interested mainly in selling the securities that must be marketed under the new organization To cite but one specific case the approximately $500 000 000 of common stock of United States Steel all went originally to the promoters and bankers who were involved in the formation of the company and represented no physical property

The formation of the large business organization also means power prestige and importance to the men who are responsible and this factor may well have importance as an incentive The president of the largest steel company or the largest automobile company or any other such industrial giant is a person of importance and influence not only in his own community but throughout the United States Even if the monetary rewards were not tremendous there would still be reason to believe that men continue to desire the tremendous power and importance that such positions involve

Types of Concentration

Large business units vary greatly both in the methods of their formation and in the results but certain general patterns can be traced By origin they may represent either expansion or consolidation The Ford Motor Company for example started as a small business and grew entirely by internal expansion until it attained its present size The Great Atlantic and Pacific Tea Company expanded in a different way leasing store after store until it achieved its present immensity On the other hand United States Steel was formed originally by the consolidation of a number of large companies The United Shoe Machinery was based on a consolidation and then expanded both by increasing its own business and buying out competitors

The final forms taken by consolidations are frequently given as three—horizontal vertical and lateral The horizontal type is well illustrated by the Great Atlantic and Pacific which has grown through the acquisition of numerous chain grocery outlets all of which do a similar kind of business Woolworth or any other chain organization is in the same category

The vertical type of consolidation includes all kinds of processes from the raw material to the finished product United States Steel for example owns mines smelters, railroads coke resources rolling mills wire mills and hundreds of related organizations Ford and other companies have expanded similarly

The lateral type of growth means the development of the control over

related industries Examples will show the situation The big four packers —Armour Cudahy Swift and Wilson—control railroads electric power production fertilizer plants glue factories land printing cotton oil production newspapers magazines terminal facilities warehouses and other related industries General Motors is interested in Delco lights Frigidaire radios electric appliances and air transportation among other things General Foods has a large line of food products which are only remotely related to each other

No one type of expansion is exclusive of the other two Many companies have grown in all three ways as witness DuPont The choice rests largely on the interests of the men in control the time at which expansion takes place and the fields that are available In many cases these industrial giants are related to each other as with the well known holding of General Motors stock by DuPont The use of the trust and the holding company will be described in the next chapter

Extent of Concentration

The progress of consolidation has been little short of phenomenal in particular fields A great railroad such as the New York Central the Pennsylvania or the Santa Fe furnishes the entire rail facilities for much of the territory which it occupies International Nickel has 90% of the known deposits of the world Railway Express monopolizes its field the Aluminum Company of America dominates the domestic market eight railroad companies dominate the production of anthracite coal, two steel companies control over half of the American steel capacity General Motors and Ford sell three quarters of the American cars three companies sell 70% of all American cigarets General Electric and Westinghouse make half of our electric machinery Numerous other companies such as International Harvester National Biscuit Company and United Fruit rise head and shoulders above their competitors

All of the companies so far mentioned are corporations and the general figures on corporations throw some light on the extent of concentration In 1933 there were approximately 400 000 corporations in the United States Measured in terms of wealth the top 15% had 53% of all corporation assets, while the top 5% had 85% the bottom half when lumped together could muster only about 2% of all corporation assets Measured in terms of income the top 69—a negligible percentage—received 30% of all corporate income while the top 6% received 80% if the bottom three-quarters were lumped together they could still show only about 3% of all corporate income

Figures on consolidations are so impressive that there is little difficulty in conveying the impression that all of American economic life is dominated by a handful of large corporations This picture would be essentially faulty since the majority of American income is still produced by indi

viduals, partnerships and small corporations All that one can say truthfully is that consolidation has tended historically to increase until today many fields have been reduced to one or a few companies This development is neither necessarily good nor necessarily bad Concentration has some advantages and some disadvantages A much more extensive study of its nature and effects is necessary before a proper attitude can be obtained

Concentration Through Cooperation

The growth of single companies until they overpower their respective fields is not the only way in which some of the advantages of large size may be obtained If two or more independently owned companies are able to attain similar business policies without actual combination they may not gain the technical advantages that go with increased size but they may obtain the selfish advantage of a decreased severity of competition, and particularly price competition Such cooperation need not necessarily be considered bad since too much competition may be just as great an evil as too little competition even though different groups of people are injured

The simplest type of cooperative action is a practice known by the descriptive phrase of following the leader ' When one company dominates a single field its smaller rivals may find profit in establishing the same prices quality and terms of sale as the big company Such action prevents the desperate competition that might ruin many concerns From the stand point of the small concern there is every reason to stop a war which the large company would probably win by virtue of its superior financial back ing From the standpoint of the large company, it may seem desirable to keep at least the fiction of competition alive, so that any threat of govern ment control can be countered with the argument that the industry is truly competitive and hence does not require control Among the industries which have played follow the leader are steel and gasoline

Competitors may agree among themselves either in writing or orally regarding any phase of the conduct of their businesses Such an agreement is illegal under our anti trust legislation, but whether or not it could be proven and punished is not so important as the fact that it could not be enforced in the courts An unenforceable contract contains a standing invitation to break it so that under the stress of competition it would be no guarantee of the keeping of the peace The extent to which such agree ments are actually in existence is of course unknown, since they are illegal and hence not publicized

During the mid nineteenth century a much used form of cooperation was the "pool ' A pool was an agreement by which competitors might limit output allocate business fix prices or share profits Two competing rail roads for example, might agree to divide the traffic between two points

equally they could either share the physical freight and passengers equally or the company obtaining more than half could pay the balance to its competitor at the end of the year Makers of pipe might agree to arrange their bids in such a fashion that each one would obtain a predetermined share of government contracts Makers of salt might fix the price and allocate the proportionate share of production that each company was to have

Pools were never very successful because of two main kinds of trouble They were illegal under the common law as well as under anti trust legislation and hence were both unenforceable and subject to direct penalties In the second place there were practical difficulties that caused most pools to collapse even without government interference The main trouble was that they did not achieve their principal aim of eliminating price and other competition Each competitor still felt the desirability of acquiring additional business—if necessary by secret rebates and other concessions—so that when a new agreement was made he would be in a favorable position to demand a larger share of the total business

Within comparatively recent years there has developed the trade association, which at times has had the effect of lessening competition The trade association is a non profit organization of the competitors in any particular industry with the purpose of exchanging information discussing common problems sponsoring research and undertaking lobbying and other propaganda Their legality will be discussed later When they have attempted directly to control prices they have always been held illegal by the courts but they have had indirect influence on prices and have definitely limited other phases of competition They were given considerable power in the control of industry under the N R A

A special type of cooperative enterprise is a marketing organization such as the California Fruit Growers Association (trademark Sunkist) Such a grouping provides a joint marketing agency for otherwise independent companies and individuals Measured from the profit standpoint such cooperation has proved valuable

Cooperation and the Competitive System

The cooperation of supposedly competing units has always been viewed askance by the American public Our traditional system of free enterprise has always assumed that each business will remain completely independent and will compete as vigorously as possible with every other business The theory has been that society benefits by a real knock down and drag out fight in which businesses seek advantage by cutting prices and improving quality With this line of reasoning any kind of business combination spells trouble for the consumer The opposite contention is that cut throat' (that is very severe) competition may result in bankrupting all th

competitors with no advantage to anyone Regardless of which side is right it seems inconceivable that the American public will allow increasing consolidation and concentration without taking some kind of action Such action may either be in the direction of restoring competition or of controlling concentration At present we are doing a little of each

CHAPTER 4

THE ORGANIZATION OF BUSINESS

Modern business is organized legally in only three basic forms—proprietorship partnership and corporation Historically the oldest and legally the simplest of them is the proprietorship in which there is a single owner who is also the manager and whose freedom of action is limited only by the general civil and criminal laws that affect all people No technicalities limit the starting of such a business A man who wants to start a hat store or a peanut stand or a garage merely obtains the necessary land buildings and equipment hangs out his sign and starts business

The greatest advantage of the proprietorship is its freedom of action The proprietor can start when he pleases and where he pleases offer any goods or services he desires set prices and quality according to his individual preference and bring the business to an end at his pleasure His name may appear on the storefront and he may dispose of the business as he sees fit He is limited only by general legislation as in building codes sanitary restrictions labor laws and by his own limitations and social pressures

Since a proprietorship is entirely the creation of one man it depends exclusively upon him for its success and herein lies a serious difficulty The financial resources of one man including his ability to borrow from his friends or the bank is usually not great His managerial capacities may not be sufficiently great and he certainly can not be in two places at the same time if he should transfer part of his power to an agent he still remains responsible for the acts of the agent unless they are so wild that no normally intelligent man might expect the agent to have such powers He might become seriously ill for a considerable period or become insane or die If any of these troubles materializes the proprietorship may well come to an ignominious end—and in fact the rate of failure of such businesses is very high

The greatest single disadvantage of the proprietorship is the complete liability of the owner for any debts that he may create in the progress of his business Such debts can be collected not only as against the assets of the business but from any property of any kind that the owner may possess —limited only by the bankruptcy law This obligation has at times been evaded by transferring most of the assets to the man s wife or to another relative or friend Such transfer is a criminal offense if it is made in pros

pect of business failure and with the object of defrauding creditors but only infrequently can this motivation be proven to the satisfaction of the court Greater troubles loom on the horizon from the possible refusal of the friend or even of the wife to restore the property after the crisis has passed The one favorable aspect of the unlimited liability situation from the standpoint of the proprietor is that his credit rating may thereby be improved if he has a long record of meeting his debts promptly and has considerable personal property

In spite of its difficulties and drawbacks the proprietorship is the most usual form of business control encompassing the major part of American economic activity Practically all farms the overwhelming majority of retail stores the great majority of professional undertakings and a sizable share of wholesale and construction concerns are proprietorships The proprietorship is practically never seen however in a bank or in a railroad or other utility It is naturally most prevalent where the need for capital is comparatively small

Somewhat more complex than the proprietorship is the partnership which occurs frequently in the same fields as does the proprietorship There are probably about 300 000 partnerships in the United States and they are most common in such professions as law and accounting and in such businesses as brokerage and investment banking Their characteristics may be described in general even though there are state differences—as for example certain states permit limited partnerships sometimes under a different name in which the usual common law doctrines are modified for particular cases

The partnership is an agreement, either verbal or written, between two or more people for the conduct of an enterprise The only advantage of a written over an oral agreement is that the terms are more clear if any later dispute arises This agreement may fix any relation between the partners that they desire, provided of course that they do not agree to any illegal acts One partner may furnish the entire capital and the other furnish his services, which is a frequent arrangement Or else each partner may furnish a certain share of the capital Profits and losses may be divided in any way that the partners desire one man might even take entire responsibility for all the losses if he were that foolish

Each member of a partnership resembles a proprietor in being completely responsible for all the debts of the enterprise No agreement between the partners can change or modify this responsibility since there is an accepted legal principle that no agreement can bind people who are not parties to that agreement A creditor of the partnership can sue the partnership and then each partner individually until he recovers his debt, and partners are responsible to the extent of their worldly possessions Clearly a partner must have great confidence in his co workers if he is to give them this great power of economic life and death over himself

The partnership has certain advantages Its formation by drawing and signing an agreement is fairly easy except for the difficulty of finding the proper partners It may enter any sphere of activity and change its interests as frequently and as widely as it desires It may attract considerable capital since several men may contribute Its management may have the advantage of diverse abilities since each partner may be active in the venture with his sphere of action set and limited by the original agreement

The difficulties of the partnership are fairly evident Most important is the feature of unlimited liability which frightens away most men with capital to invest such a capitalist can usually find very few men in whom he has so much confidence that he will make them partners Then too the partnership has an uncertain life if any member dies goes bankrupt becomes insane or resigns the partnership lapses and a new agreement must be made Finally there may arise troubles as between the partners The usual agreement provides no machinery to resolve differences of opinion with the consequence that the affairs of the concern may suffer severely from any dispute between the partners

The Corporation

The increasingly important form of business organization in the United States is the corporation Although corporations number only about 400 000 which is only a fraction of the number of proprietorships and but slightly greater than the number of partnerships they average much greater in size and output than do the other forms They do about half of American business exclusive of agriculture

Corporations tend to concentrate within particular industrial fields Practically all public utilities and financial institutions are corporations Corporations produce over 90% of the output in car construction and repair cigars and cigarettes cotton goods electric machinery flour iron and steel wholesale packed meat motor vehicles petroleum refining the publication of newspapers and magazines In some of these cases the actual proportion of corporations as compared to proprietorships and partnerships is not nearly as high—for example only 25% of the cigar and cigarette companies are incorporated and yet they employ 86% of the labor and produce 96% of the product 33% of the flour and grist mills are corporations but they employ 85% of the labor and produce 91% of the output The explanation is that the corporation averages larger than the proprietorship or partnership

Many corporations are almost inconceivably large and rich—which of course is not denying that thousands of them are quite small, as was apparent from the corporation figures given in the preceding chapter Those corporations with assets of over a billion dollars and which may therefore without exaggeration be called large, appear in the following table The figures are from 1936 and are in billions of dollars

Metropolitan Life Insurance Co	$4 2
Prudential Life Insurance Co	3 1
American Telephone and Telegraph Co	2 9
Chase National Bank	2 3
Pennsylvania Railroad	2 2
New York Life Insurance	2 2
Standard Oil of New Jersey	1 8
National City Bank	1 8
Guaranty Trust Co	1 8
Southern Pacific Railway	1 8
United States Steel	1 8
Equitable Life Assurance	1 8
New York Central Railroad	1 7
General Motors	1 4
Consolidated Edison	1 3
Bank of America	1 2
Atchison Topeka and Santa Fe	1 2
Cities Service	1 2
Mutual Life Insurance	1 2
Baltimore and Ohio Railroad	1 2
Commonwealth and Southern	1 1
Union Pacific	1 1
Continental Illinois Bank and Trust	1 1
Northwestern Mutual Life Insurance	1 1
Associated Gas and Electric	1 0
Bankers Trust	1 0

Only slightly less wealthy are such companies as Standard Oil of New York DuPont Bethlehem Steel, Ford Motor Company and Anaconda Copper

Certain reservations should be noted concerning any list of large companies The value of assets changes from year to year and consequently the comparative size of the companies changes More important, the valuation of corporation assets is a somewhat speculative matter since industrial giants are not bought and sold like cigarettes so there is no generally accepted market value The usual types of valuation are either (1) original investment allowing for additions and depreciation (2) the cost of reproducing the existing plant and equipment, minus depreciation (3) a figure derived from capitalizing the earning power of the company (4) a combination of the other three In some ways the final figure is a complete abstraction, but it may become very important with the public utilities when some government commission strives to fix rates so that they will produce a fair return on the investment

Chartering a Corporation

A corporation is an artificial person—an individual created by the exercise of the law making power Such a synthetic individual is a compara

tively recent invention While even in Roman times there were religious and municipal corporations and while early modern times saw such organizations as the East India Company and the Hudson Bay Company the corporation device was not much used prior to 1800 Corporations were difficult to call into existence requiring special acts of the legislature and were generally considered not only undesirable as a violation of the idea of laissez faire but also inefficient In the United States they had no important development until about the middle of the nineteenth century at which time the various state legislatures passed general incorporation laws obviating the former need for each company to have a special legislative act

Corporations may be chartered by either a state or the national government In actual practice nearly all of them are chartered by the states although a few such as the American Red Cross and the Boy Scouts of America have federal charters Most corporate charters are obtained by private business religious educational or philanthropic groups but they may also be obtained by the government itself In fact there has recently been a definite trend in the direction of the federal government chartering more and more corporations to transact various phases of its business Examples are the Federal Commodity Credit Corporation Emergency Housing Corporation Federal Deposit Insurance Corporation Federal Farm Mortgage Corporation, Reconstruction Finance Corporation

Since the states charter corporations and since no two states have ever quite agreed on uniform terms for any type of legislation there can be no surprise that state corporation laws vary The most usual requirements are that there be at least three incorporators of whom at least one shall be a resident of the state that there shall be an office in the state that regular reports be issued and that there be at least a minimum capital Most of these simple requirements may be evaded by the use of dummies In fact states have tended to compete in ease of incorporation so that they may attract the business of chartering companies for the advantage of the fees involved At last reports Delaware was getting a majority of the transient business

The charter of the corporation specifies such matters as the name the type of business the location of the offices, the capitalization the rights and powers of stockholders and of officers These points may be given a very specific and restricted statement or the corporation may be given a broad grant of powers A charter has even been granted in which the corporation could engage in practically any type of business at any place except within the borders of the state giving the charter

Possibly the most interesting legal characteristic of the corporation is the fact that in the eyes of the law it is a person with the power to make contracts and other agreements sue and be sued own property It is held by the courts as having the protection of the Fifth and Fourteenth Amend

ments to the Constitution, although there have been some criticisms of this point of view, particularly by Justice Black of the Supreme Court within recent years

As an individual the corporation is subject to both civil and criminal laws Corporations have been convicted of keeping a disorderly house, of knowingly mailing obscene literature of unlawfully catching salmon, of committing a libel They have been tried but not convicted for treason and for kissing a girl Any criminal act must of necessity have been committed by an agent of the corporation and there is great difficulty in proving that such an act was authorized by the corporation and not merely the unauthorized invention of the agent Furthermore the punishment of a corporation for a crime is slightly difficult since imprisonment is hardly a possibility Fines can be assessed however and legal death is conceivable A corporation like any other individual has the constitutional right to engage in interstate commerce anywhere in the United States without state interference On the other hand it has no inalienable right to engage in activities other than interstate commerce, and consequently in such fields the states may pass discriminatory or even prohibitory legislation against out of state corporations With the recent tendency of the federal courts to expand the meaning of interstate commerce the freedom of the corporation is increasing Furthermore the corporation can take many of its legal cases to the federal courts, since in most legal actions the corporation is foreign —that is it has been incorporated in some state other than the one in which the case is brought

Raising Corporate Funds

The corporate form of organization is a particularly effective device for the raising of funds—a fact which makes understandable the greater average size of corporations Investments in corporations take three general forms each represented by a different form of corporate security—bonds, preferred stock and common stock These securities vary in return and in risk, and are divided into sufficiently small units to attract any possible amount of capital Their popularity is attested by the fact that they represent almost half of the wealth of the United States and over half of the funds of all probated estates

The general and ordinary characteristics of corporate securities can be described, but one should always remember the existence of numerous variations A thorough knowledge of any issue depends upon a careful study of the statement printed on the face of the certificate (which is in reality a contract), and a thorough knowledge of both the applicable legislation and the pertinent court decisions Even with all this information mistakes remain possible

A bond is an evidence of debt on the part of the corporation The bond holder is a creditor—not an owner—and his return is called interest—not

a dividend A bond has a fixed face value usually some multiple of $100 although the purchaser may actually have paid more or less than the face value depending upon the current interest rate the condition of the com pany and general economic factors There is a fixed date of maturity at which time the bond should be paid off in cash frequently however new bonds are issued in the place of the old Ordinarily the bonds may be called in and retired before the date they are due the price to be paid in such an event is a part of the contract Interest on bonds is paid at a fixed rate as for example $5 a year on a $100 bond and may be paid semi annually or quarterly The bondholder practically never has a vote in the affairs of the company

In general bonds are considered more secure than stock and hence pay a smaller return They constitute a mortgage of the property and receive priority in the payment of interest charges and in being paid off if the com pany dissolves Bondholders can insist upon receiving their interest each year regardless of the earnings of the company upon any failure to pay interest the bondholders can institute foreclosure proceedings and apply for a receiver If the property is foreclosed and sold the bondholders are paid off before anything goes to the stockholders—with the usual result that the bondholders take over the ownership of the property Naturally the bondholders may forego their interest for any year if they think such action desirable

While bonds are in general considered safer than stocks they vary greatly among themselves both as among various companies and as among various bonds of the same company As between companies the bonds of a very sound company will ordinarily be better than those of a less favored corpo ration and this difference shows in a lower interest rate for the better bonds In addition, any one company may have as many as six or eight kinds of its own bonds and these may vary in security There may be first second third and even fourth mortgage bonds on the same property in the event of the dissolution of the company the holders of these bonds would be paid in that order Bond issues may be based on various properties of the corpo ration or upon no specific property in which case they are called deben tures There are even income bonds ' which give a return only if earnings are sufficient and hence are in many ways similar to stock

One kind of non industrial bond is seen frequently and that is the gov ernment bond It has the same characteristics as a private corporation bond except that it is never secured by any specific property depending entirely on the credit and power of the United States government As with other bonds it may or may not be registered—that is, the owner recorded and interest sent to him If not registered it is a coupon bond with perforated coupons each marked with the date and amount of one interest payment The owner merely clips the proper coupon and presents it for payment

The second type of security is preferred stock The owner of one or more

shares of preferred stock is not a creditor in his relation to the business but an owner and consequently his return is called a dividend In some ways preferred stock resembles bonds It has a definite face value usually in some multiple of $10 but this sum is not necessarily the amount that the owner paid for the security It has a definite rate of return as for example $6 a year which is higher than the bonds of the same company It can ordinarily be called in and retired by the company at a specified price Unlike the bond however it has no date of maturity, for ownership does not come to an end at any prearranged time

Preferred stock has the next claim on the earnings of the corporation after the payment of the bonds and this junior claim is the reason for a somewhat higher rate of return In very rare cases preferred stock participates in dividends along with the common stock under particular conditions In the event of the dissolution of the company by bankruptcy or otherwise the preferred stockholders are paid after the bondholders Practically never does the preferred stockholder have a vote in the management of the company and hence we have the very peculiar situation of a large class of owners with absolutely no voice in the control of their own property

Preferred stock may be either cumulative or non cumulative and the only way of telling which is the case is to read the terms printed on the stock If cumulative any dividends not paid for one or more years must be made up before there can be any dividends on the common stock If non cumulative these arrears can merely be forgotten which presents the possibility of stopping all dividend payments for several years after which the greater share of the accumulated funds will go to the common stockholders No matter what happens to the company the preferred stockholder can not institute bankruptcy proceedings since he is an owner and not a creditor He holds a certificate of ownership in short

Common stock also represents ownership and consequently any return is called a dividend Some stock has a face or par value which is usually some figure between one and a hundred dollars but most stocks are without par value In either case the situation is really the same since the par value has no meaning Such a hypothetical sum is probably not the original price paid for the stock when it was issued—in fact the stock may have been given as a bonus for the purchase of bonds It is probably not what the present holder paid since he paid a market price dependent mainly on the hope of future dividends It is not the basis for making dividend payments and it has no importance if the company is dissolved Hence the par value of common stock is nothing but a meaningless abstraction

Common stockholders can ordinarily vote in the affairs of the company although sometimes in such a company as American Tobacco there is both an A and a B issue with only one of them voting No arrangement can be devised to prevent all common stockholders from voting since these people

are the owners and some of the owners must be allowed the power to control their own property

Dividends on common stock are paid according to the earnings of the company and may be high low or non existent which produces greater fluctuations in the price of common stock than in that of other securities The common stock divides whatever remains after running expenses have been met interest paid on the bonds and dividends on the preferred stock every share of common stock receives the same payment even if there are two classes of such stock Many companies make some effort to keep the dividend rate fairly stable putting large earnings into a surplus fund out of which come dividends in poorer years but there is no necessity of doing things this way If the company should dissolve the common stock divides what is left after the bonds and preferred stock are paid in full Obviously common stock has no required rate of return and never comes due to be retired

Running the Corporation

The basic control of a corporation is vested theoretically in the body of its stockholders—or at least in that share of its stockholders who can and do vote The usual corporation has a stockholders meeting once a year at which time officers are elected and important matters of policy decided The stockholders can control any aspect of the business, but in ordinary practice most decisions are left to the officers—if for no other reason than because there may be thousands of stockholders and any attempt that they might make to govern the detailed operations of the company would be worse than useless In any voting each stockholder casts votes in proportion to the number of shares that he owns

The main policy making group is usually the Board of Directors, although depending on the charter and the laws of the state the Board may have anything from very complete powers to practically none In some cases the Chairman of the Board is more important than the President of the company and the Board is in almost continuous session controlling even the more detailed operations of the company, but on the other hand the Board may meet but infrequently and have very little power

Membership on a Board of Directors depends on election by the stockholders with very few other qualifications necessary in becoming a director In most cases the director is required by law to have one or more shares of the common stock but quite frequently his interests are very small There are cases on record where directors did not know that they had such jobs and attended no meetings

The officers of the corporation including notably the president, one or more vice presidents secretary and treasurer are appointed by the Board They may themselves be members of the Board—in fact it is possible to be both president of the company and Chairman of the Board at the same

time Normally the officers make the detailed day by day decisions that carry into effect the general policies of the Board but as has been sug gested the relations and powers of the two groups may vary widely from company to company

Below the principal officers is a large hierarchy of officials and workmen extending down through the cheapest day laborer The two general types of organization are the divisional and the functional In the functional type each vice president or other executive officer is in charge of a particular department as sales credit, production and the rest regardless of their geographical location With the divisional type each plant or office would be run as an independent unit, subject only to the control of the central office Volumes have been written describing different possible types of organization, with their comparative advantages and drawbacks Even with the best possible organization there is some doubt as to whether the very large company can ever be as efficient as the small plant owned and managed by a single person of ability

Advantages and Disadvantages

The corporation just as any human institution, has both advantages and disadvantages Which loom the larger depends in part on the portion of the stadium in which you have your seat The basic advantage is the possibility of gathering sufficient amounts of capital from diverse sources to permit the running of a large business The existence of different types of securi ties, with their variations in both amount and appeal make possible the collections of tremendous sums of capital such as individual enterprise or partnership can not match

The character of corporation securities makes them readily transferable from one person to another Within seconds they can pass from hand to hand in any desired amount This ease of exchange is one of the factors encouraging the investment in corporate securities for each potential in vestor recognizes that if for any reason he wishes to get his money back or to buy other securities he can do so Of course such transferability depends on the assumption that the corporation will not in the meantime go bankrupt

Another inducement for the investor to put his money into the corpora tion is his ability to diversify his holdings because of the comparatively small value of each share of stock and of each bond With a limited capital he could establish probably no more than one proprietorship which would concentrate his risk very highly, to say nothing of the drain on his time His opportunity to enter a partnership would be greatly limited and such action financially dangerous On the other hand he could buy some share in twenty or fifty or even a hundred corporations, with a consequent spreading of his risks

To the further advantage of the investor, every corporation has limited

liability for its stockholders In consequence the possible loss to the stockholder can be foreseen and will certainly not take his entire wealth as may be the case in other types of business investment Ordinarily the liability of the stockholder is only for the amount that he has invested Sometimes as with banks and other financial institutions the liability may be double or even triple but in any case it has definite limits

Another advantage of the corporate form of business organization is that the corporation does not die as does the individual Even though its personnel changes from time to time the corporation itself may continue to live indefinitely subject only to the vicissitudes of business mortality It is consequently the only person—albeit an artificial person—to have found the secret of worldly immortality

The corporation is also the one business form in which control remains unified even though capital is drawn from many diverse sources The partnership can theoretically be expanded to include hundreds or even thousands of people, but the result would probably be a confusion of councils and a dispersion of authority In contrast the corporation might have a million owners and still concentrate all powers in one man

An additional advantage of the corporation to its users is the possibility of evading certain responsibilities The action of a proprietor is easily traceable to him and he can be easily punished On the other hand there is difficulty in determining whether a particular act performed by an employee of a corporation is done on the orders of the corporation or on the agent s own responsibility While corporations have been convicted of crimes such convictions are exceedingly difficult to obtain

Finally the corporation may grow to immense size and thus obtain a position of dominance in a particular industry—even to the point of being able to control prices in that industry Monopoly prices are more possible with corporations than with any other form of business enterprise Such growth has been encouraged by our anti trust laws which make almost any other kind of cooperation illegal

Certain defects of the corporate form have also become evident—defects either from the standpoint of business itself or from that of other sections of society While several such troubles will be described in the more detailed account appearing in the next chapter a brief statement can be made at this point The organization of a corporation is more difficult and expensive than the creation of any other business form The scope of activities is ordinarily limited in the charter thus decreasing its flexibility Special obligations sometimes exist, as the making of reports, the payment of special taxes, the maintenance of particular offices The corporation is considered by its very nature to be quasi public and hence subject to governmental regulation to a greater degree than the proprietorship or partnership

Certain characteristics listed earlier as advantages might well be considered as disadvantages from a different point of view Monopoly is not

commonly considered to be a social advantage nor is the evasion of respon sibility by officers and employees always considered desirable Furthermore the very size and complexity of the corporation encourages the practice of fraud as by promoters the bankers the officers Large size decreases the importance and power of any single owner to the point where his interest in the business becomes negligible and the possibility of his victimization infinite

Corporations Cooperate

Certain methods for the cooperation of independent businesses were discussed in the previous chapter and such methods may include corpora tions as well as proprietorships and partnerships Corporations can enter pools trade associations cooperative marketing organizations and the rest In addition however the corporation has certain other possibilities more or less unique to itself

A very common method of attaining at least a minimum of uniformity of management as between corporations is the use of interlocking director ships If for example one man were a director in every important steel company or plow company or fountain pen company a very large step would have been taken toward standardizing competitive practices and stabilizing prices presumably for the good of all the competitors Individ ual cases have actually occurred where one man has been a director of sev enty or more companies at the same time Such an interlocking does not stop competition necessarily and in fact may not even lessen it but the chances are the other way

The effect of interlocking directorates in lessening competition has not eluded the recognition of the law makers when they have striven to preserve and strengthen competition Within certain limits interlocking directorates are forbidden by the Clayton Anti Trust Act The effect of this provision has been negligible however since evasion is extremely easy The use of a dummy lawyer or personal friend or business associate or office boy attains the desired objective and avoids violation of the law

A method of combination which was fairly popular about a half century ago but which is little used at present is the trust agreement The first industrial trust was that of Standard Oil in 1879, which was followed by similar combinations in whiskey tobacco and other commodities Time has reduced this method to a position of lesser importance

Originally a ' trust referred to property held in trust for legally incom petent people such as minor heirs and inmates of institutions and this meaning is still widely current In its industrial form the trust is usually, but not inevitably a method for combining corporations The individuals forming the trust transfer the legal title to their property—in this case corporation securities—to a group of trustees, and in return receive trust certificates which correspond to their parts in the new venture Ordinarily

the life of a trust is limited—many states specify twenty years—but for this length of time the combined property is completely under the control of the trustees

The effect of the trust agreement should be fairly evident Assume for example that three men hold the controlling interests in three fire screen factories and that these three factories control the major part of the output of fire screens The three men want to avoid disastrous competition—in fact they would like to avoid all competition Physical consolidation is possible but none of the three wants permanently to lose control of his own factory Agreement among the three is another possibility but is probably illegal and might be easily abrogated particularly if one of the men should die In consequence they pool their stock in a trust agreement and are thus assured that for at least twenty years the three factories will be run along similar lines

The trust agreement has lost favor within recent years partly because it is slightly awkward and unsatisfactory in itself and partly because the Supreme Court has tended to look on it with suspicion in anti trust cases but more because a better and entirely legal form has been devised The new form is the holding company which is simply a corporation chartered for the express purpose of holding the controlling stock in other corpora tions Such a corporation has all the advantages of any corporation in concentration of management and curiously enough the courts have never seen in it a violation of the anti trust acts as a combination or conspiracy in restraint of trade'

The working of a holding company is simple Reverting to the fire screen example given earlier the three men would form a fourth corporation and hand over to it the stock in their individual companies The three men might divide the stock of the new company in any way they desired In fact they might issue bonds and preferred stock in sufficient amount to pay for their original stock and then keep the voting common stock of the new company as a reward for their activities of promotion, thus maintaining their control of the fire screen business while they no longer had a penny of their own money invested

A holding company need not necessarily be chartered by a group of men who already have the control of companies to be combined It may well be chartered by men who seek to obtain the control of one or more com panies At the maximum the new company would need to buy only 51% of the voting stock of each of the old companies To make this purchase the new company might obtain most of its funds from bonds and preferred stock neither voting Hence a comparatively small investment will control the much larger investments of the operating companies A very large num ber of our major industrial corporations are holding companies—for exam ple General Motors and American Telephone and Telegraph American Tel and Tel is the largest non financial company in the United States,

with an investment in the Bell System in 1934 of $4 750,000 000 and an annual revenue of well on toward a billion

The process of having one company own another can be repeated almost indefinitely with one holding company piled upon another as long as the ambitions of the incorporators continue Even a tyro in mathematics can create an imaginary pyramid in which the top holding company with an investment of say a hundred dollars, can hold an operating company with a capital of a hundred million In actual fact it has been claimed that a holding company of twelve men with a capital of $1200 was able to control 60% of the banking capital of Detroit

A good example of the pyramiding of holding companies was in the rail road empire created by O P and M J Van Sweringen Following the con trol straight down from the top and omitting collateral holdings and con nections the Van Sweringens (a partnership) held 80% of the Vaness Company which held 50% of the General Securities Corporation which held 41% of the Allegheny Corporation which held 54% of the Chesapeake and Ohio Railway which held 81% of the Hocking Valley Railroad The second third and fourth of these concerns were holding companies and the fifth and sixth were operating companies Analyzing the investment figures the Van Sweringens provided less and less of the capital as the pyramid descended, until in its last stage they provided only 25% of the assets of the Hocking Valley Railroad and but 98% of the Chesapeake and Ohio

Holding company systems have become very complicated with half a dozen or so layers of companies hundreds of subsidiaries and then cross holdings of stock Fairly illustrative was the Samuel Insull system which at its height was the third largest utility grouping in the country producing an eighth of the electric power of the United States and with 4 500 000 customers Its top holding companies were the Insull Utility Investments, Inc and the Corporation Securities Company of Chicago New companies were floated by borrowing money on the stock of the old ones and the whole system was so intricately interrelated that several years of investigation failed to clarify it completely The failure of the Insull system was one of the important factors in the background of our present legislation designed to simplify utility holding company set ups

While holding companies can control large numbers of operating com panies, the conclusion should not be drawn that in this way they immedi ately absorb all of the operating profits All earnings of the operating company are returned to security holders in proportion to their investments, and similarly up through the pyramid to the top Presumably the Van Sweringens, with only 25% of the Hocking Valley investment will get only that proportion of the return no matter the number of the hands through which the money passes There would be some variation of course, depend ing on the return on various kinds of securities

Since a holding company presumably is not developed merely for the

mathematical recreation of its promoters then there must be some method of making it pay in dollars and cents Simplest for the promoters would be the plan to vote themselves directorships and other remunerative offices in all the companies controlled and by means of high salaries and bonuses milk off all the funds that might otherwise be returned in dividends to the stockholders Equally simple is having the operating companies pay considerable shares of their earnings to the top holding company for financial advice legal help or any other plausible luxury Such agreements are easy to obtain since the same men control both sides of the bargain By their operation the profits are drawn past all the intervening investors and brought back directly to the top men These are but two of a multitude of ways in which the holding company can be utilized for the benefit of the insiders Their number is a tribute to the ingenuity of man in finding ways to obtain money at the expense of someone else

CHAPTER 5

THE CORPORATION AS A LIVING ORGANISM

The corporation is a human organization designed like any other business venture for the making of profits But this statement is so simple that it tends to obscure many of the facts The corporation is a person by legal fiction, but in fact it comprises hundreds and even thousands of human beings each with his own interests and ambitions To say that the corporation wants to make money is to miss entirely the equally important fact that every group and every person associated with the corporation desires to attract the largest possible share of such earnings In fact there are at times related groups which may not even want the corporation to show a profit but may actually prefer to see it go bankrupt

The theme of this chapter is then the conflicting forces within the corporation Each large interested group will be surveyed in turn to indicate its general desires and the types of action that are possible Each of these groups will be treated in general as a uniform force even though there may actually be splits of opinion since only a dictatorship attains unanimity

Promoters

The men who are responsible for the formation of the corporation are the first in point of time to be interested in it Such men may be interested primarily in the creation of an organization to make and sell a product which they desire to control They may however desire to create a holding company to monopolize the field and establish a monopoly price But on the other hand they may not be at all interested in the actual operations of the company, but only in the profits that may be derived from its creation

Whether or not the promoters are actually interested in the new company as a going concern they may well retain its control at no cost to themselves For example the Dodge Brothers Motor Car Company was bought by a group of bankers for a reputed $146 000 000 It was reorganized and the securities of the new company were sold for an estimated $160,000 000 The difference, minus the expenses of promotion, represented profit to the promoters who also retained ownership of the 500 000 shares of voting stock When United States Steel was organized all the common stock was given to the bankers and promoters as a bonus The gain for the promoters was around $250 000 000

Extremely large profits to the promoters must be paid by someone but

that someone may vary Sometimes the investing public suffers when the total value of the securities is greater than the profits will support Some times however the profits are sufficient to provide for inflated securities and then either labor suffers in lower wages or the consuming public pays in higher prices In this latter case however there is no reason to think that a fairer original capitalization would necessarily have meant either higher wages or lower prices since neither wages nor prices are ordinarily set in relation to profits

Promoters then can run counter to the interests of other members of the corporation by either increasing the amount of capitalization until proper returns are impossible or depleting the cash resources of the company or retaining an inefficient control after the company is organized The extent of these abuses is problematical

Investment Bankers

In many cases the promoters of a large consolidation are investment bankers since bankers more than most people have proper facilities for such action Bankers acting as promoters are subject to the same influences that we have noted concerning promoters in general Both of the companies mentioned specifically in the last section were floated by bankers

Bankers also have importance in the running of many corporations Any large company needs additional loans and stock flotations from time to time and for that purpose usually has connections with a particular bank ing house Because of this association the bankers are sometimes given one or more seats on the Board of Directors and are at times consulted in the management of the business When bonds or stock are floated the bankers may retain at least a small part of the issue but in any case they are inter ested in what happens to it since they have sold it to their customers and too many bad flotations would endanger the confidence of investors in that banking house

Bankers are also important in the making of short term loans to both large and small corporations In advancing such a loan the banker is inter ested not only in the existing assets of the corporation but also in the proba bility of profitable operations in the future The loan may be made contin gent on the business accepting the particular policy the bankers think will best safeguard their interests Bankers have even been known to refuse loans as a way of demolishing an undesired business

The bankers and their banks are themselves investors, in which capacity they have large funds at their disposal As is only prudent they are inter ested in the management and policies of the companies in which they invest As any other large investors they often try to have adopted the policies that they think most desirable In some cases as that of anthracite coal they dominate the industry

The interests of the bankers are generally conservative partly because

bankers are conservative by training and tradition and partly because their investments tend to run toward bonds and short term loans In consequence they are ordinarily opposed to wild experiments or hazardous expansions They generally prefer safe and conservative policies which will at least pay interest on the bonds They are likely to be more interested in increasing business by consolidations and agreements than by harsh competition In these desires they may well run counter to the preferences of the stockholders and management Incidentally, the bankers will usually prefer a suppressive policy in respect to labor since they are quite remote from the business and do not see labor troubles at first hand

Lawyers

Passing attention should be given to a group which usually is not considered seriously—the lawyers Every corporation of any size has one or more lawyers, and a really large company has whole battalions of legal talent Presumably the main job of the lawyer is to keep the corporation out of legal trouble but on the other hand the complete absence of litigation would end the lawyer's job and consequently he can not be blamed too severely if he keeps himself busy He is one of the few people in the corporation who might actually benefit from the foreclosure and sale of the property Under foreclosure proceedings he might become the receiver and in any case there are considerable profits to be obtained in the process of reorganization Some people have been sufficiently unkind to charge that various companies have been wrecked from the inside and that the reorganization business has become a racket within the past decade

Bondholders

The interest of the bondholders is fairly evident They are not primarily concerned as to whether the company makes large profits or not, except in so far as these profits are put into a reserve fund to care for future interest on bonds They are not particularly interested in any policies of expansion, and are definitely hostile if such policies put present earnings in jeopardy

The difficulty of the bondholder is that in normal times he has little if any voice in the affairs of the company The legal theory that he is a lender of money and not a part owner has almost entirely excluded him from any vote Now and then large bond holdings are given representation on the Board of Directors, but such a situation is rare In hard times the voice of the bondholder becomes more authoritative If there is any danger that the company will some day not be able to pay interest on the bonds a sudden solicitude for the interests of the bondholder becomes evident If he is properly placated he may be persuaded not to institute foreclosure proceedings but rather to forego his interest in the hope that the fortunes of the company will improve In such times a committee of bondholders may exercise a powerful influence in the affairs of the company

There has been some sentiment that the bondholder be given a recognized voice in corporation affairs by being allowed to vote While there is some theoretic justification for this program it is not really very hopeful In good times the bondholder would probably not be sufficiently interested to vote and even if he did vote his influence would be entirely conservative which might be a positive drawback to the company In bad times he would probably have no more or different influence than he has at present, so that conditions would not be changed

In the event of bankruptcy and foreclosure the usual reorganization plan transforms the bonds into stock and eliminates the old stock That is the original owners lose their investment and the lenders become the new owners Theoretically one could conceive of bondholders who might be desirous of forcing a foreclosure so that they might take over the property Actually however such a development is the last thing that the average bondholder wants What he does desire is that interest be paid regularly and that he have none of the troubles or responsibilities of ownership He is a creditor and hopes to remain so

Preferred Stockholders

The preferred stockholder is in something of an anomalous position He allows the company to use his money and yet he is technically an owner and not a lender As an owner he can raise no objection if he gets no return while at the same time he has no voice in determining the policies of the company since he ordinarily has no vote He is a speechless owner who looks more like a lender Only custom based on legal distinctions can maintain such an artificial situation

The preferred stockholder is the forgotten man of the corporation His desires if he has any desires, are unknown In good times the common stock has the power of control and in bad times the bondholders increase in importance but never does the preferred stockholder blossom into even a brief bit of glory Once in a long time he may be given representation on the Board of Directors but this translation to a seat of power is about as rare as an Irish Lutheran

Should any effort be made to give the preferred stockholder a trifle more power? There are those who hold that he should at least be given a partial vote so that his point of view would be given expression This suggestion receives no great support and in fact there is considerable doubt whether any great number of preferred stockholders would take advantage of the opportunity

Common Stockholders

Legally and theoretically the corporation is run by the holders of common stock—or at least by those stockholders with the vote Presumably their aim will be to attain the maximum profit for themselves They must pay

interest on the bonds, but they should try to borrow money at the lowest possible rate of interest They must pay the necessary dividends on preferred stock although they might try to retain a portion of such payments if the stock is not cumulative They must hire management and labor and presumably they should try to pay as little as possible to get maximum results—that is they want efficiency in operation but would like to pay as little as possible for this result As to disposing of the final product if the owners pursued purely economic ends they would like to sell the poorest possible product at the highest possible price Naturally their desires will be tempered both by their personal ideas of morality and by the condition of the market including their desire for customer good will

The theoretic statement of the last paragraph fits in a general way the situation of the small corporation in which comparatively few people hold the great majority of stock and meet together to elect officers to carry out their joint will An investigation of 1935 showed that for 1755 corporations the officers and directors held about a fifth of the total stock, which probably indicates that in most cases the stock was fairly closely held and that the officers were frequently large investors But what of the large corporation? Here the situation is far different and the theoretic generalizations must be revised and even discarded in many cases as they collide with the hard facts

The large corporation is usually characterized by great numbers of investors each with a comparatively small holding This situation is to be expected, since one of the great advantages of the corporation is its power of collecting small sums of money from thousands of people and of concentrating the management of the resulting enterprise Then too many companies have made conscious efforts to obtain wide distribution of their stock as a method of encouraging good feeling on the part of their labor their customers and the public in general The utilities in particular have tried to forestall government regulation by inducing thousands of people to have financial interests in the companies this tendency was specially evident during the 1920s

The three most widely held American stocks are United States Steel Pennsylvania Railroad and American Telephone and Telegraph The expansion of the number of their stockholders from 1905 to 1935 was little short of miraculous United States Steel increased from 20 000 to 188 000 Pennsylvania Railroad from 40 000 to 230 000 American Telephone and Telegraph from 18 000 to 664 000 The best study of this situation is A A Berle Jr and G C Means *The Modern Corporation and Private Property* (1933) from which much of the following material is drawn The authors studied the 200 largest non fiscal corporations and found that in the 144 companies for which they could obtain the proper information that only twenty with 5% of the total assets had less than 5 000 stockholders apiece 71 of them each had over 20 000 stockholders

The large number of stockholders inevitably means that no one man or company controls any large share of the stock For the three companies mentioned in the preceding paragraph no one individual owns as much as 1% of the stock and other large companies are similar Even when a large block of stock is held as a unit it is frequently owned by another corporation which itself has widely scattered stock

Attitude of Stockholders

With this wide dispersion of stock no single owner has sufficient stock to make his voice inevitably important in the affairs of the company Consequently the great majority of stockholders exhibit little active interest in management—particularly if dividends are paid regularly Consider for example the position of a Chicago resident who owns ten shares of Pennsylvania Railroad stock His only possible connection with the management of the company is attendance at the stockholders meeting which is held once a year He may of course go to the meeting but since the gathering is held in Philadelphia the cost of attendance would be greater than any conceivable return from the stock in the next generation In fact the owner would probably spend more than the total value of his stock And even then he would have no voice in the affairs of the company since his ten votes are but an infinitesimal fraction of the total votes He would of course hear the officers reports at first hand instead of reading them would probably get free cigarettes and might even be treated to a cold lunch Now and then stockholders attend convenient meetings as a mild form of amusement or to try to catch the president in some violation of proper rules of order Most stockholders however prefer to stay home

Confronted by his own helplessness the stockholder has only one or two real options He can sign and return the proxy blank that is sent to him each year or he can throw it in the wastebasket A proxy blank is the authorization for someone else (ordinarily representatives of the management) to vote the stock The list of stockholders is only in the hands of the management so signing the proxy blank helps to keep the existing management in power Discarding the proxy blank will probably have the same effect The final alternative of the stockholder in the event that the affairs of the company seem to be going badly is to sell his stock and buy something else

Under these circumstances stock is one of the more peculiar forms of property It represents a part of ownership which is actually and physically indivisible Frequently the stockholder has never seen any of the property to which he has a claim of ownership and usually the company is anything but enthusiastic about any display of interest Sometimes the owner has but the vaguest idea of what the company produces Obviously he can do nothing to make his property worth either more or less He has no control over the company over the stock market or over general business condi

tions all of which are important to him His ownership is not active but completely passive

The stockholder has his greatest interest in dividend checks and in the stock market where he can see the value of his holdings rise and fall—often spectacularly—from day to day Most large corporations have their securities listed on a stock exchange which means that the stockholder can figure from the evening paper whether that day has made him richer or poorer This comparative wealth or poverty, often quite fictional can be translated into fact on a moment s notice by buying or selling on the exchange

A passive owning of pieces of paper with one eye on dividend earnings and the other on stock exchange quotations changes vastly the traditional concept of the owner of industry as a person who runs actively the busines that he owns The slight influence that the stockholder possesses is exerted toward more dividends Being an absentee owner the stockholder is little interested in how his corporation treats labor or the general public or in fact how it treats other security holders The consequence is that the management feels pressure to obtain immediate dividends regardless of the long run effects of its policy True the members of the management might later be walking the streets if their policies hurt the company but they would attain this unhappy state even sooner if they stopped paying dividends Some exceptions to this generalization will appear later

Control of the Corporation

If the stockholders have tended to lose control over the companies they own who has succeeded them? Berle and Means in the book cited earlier divide present methods of corporate control into five general types Following is a description of these types the percentages refer to the 200 corporations studied by Berle and Means

1 Almost complete ownership by a single individual or small group of associates In this situation ownership and management are exercised by the same people Such control exists in 6% of the companies with 4% of the wealth, and is the least common type for this group of corporations The presumption is that with modern large scale business with its need for great funds this type of ownership will decrease rather than increase

2 Majority control by an individual or by a small group When a majority exists and acts together it can certainly exercise control and over ride any minority—probably a desirable situation in general, since someone must control if there is to be any action If the majority is inefficient the minority may be adversely affected but there is little reason to think that the minority is more likely to be right than the majority A sizable and compact minority group may actually have some influence in the running of the business either as a matter of courtesy or because certain major decisions may require amendment of the charter or some other act which

by charter provision requires a two thirds vote This type of control exists in 5% of the companies with 2% of the wealth

3 Control through a legal device Such devices have been described earlier in other connections Pyramiding has been illustrated in the control of the Chesapeake and Ohio by the Van Sweringens The trust arrangement has been described Non voting stock has been described a similar result can be obtained by giving part of the stock proportionately more votes In any of these cases control can be maintained by an investment much less than the cost of a majority of the stock—in fact the cost may be but a small fraction of the capitalization This type of control exists in 21% of the companies with 22% of the wealth It seems firmly entrenched except with the coming of bankruptcy

4 Minority control In many companies no single individual or small group has a majority of the voting stock but one person or group may have an important minority holding which may act as a nucleus about which other stock clusters and thus obtain and hold control of the company Such control may be challenged from either of two sides Other people may buy many shares of stock or outright control and obtain dominance Or the management may become antagonistic and assume the control by its hold on the proxy machinery An interesting case of such a struggle occurred in Standard Oil of Indiana when John D Rockefeller Jr tried to oust Col Stewart Chairman of the Board Rockefeller held about 15% of the stock but Stewart controlled the proxy machinery and refused to give Rockefeller a list of the stockholders Rockefeller then advertised for proxies and finally obtained enough to win in a very close battle The importance of the control of proxies is clear for Rockefeller was a well and favorably known man and Col Stewart had received much public disapproval but even then the fight was close This type of control exists in 23% of the companies with 14% of the wealth

5 Management control with no important ownership When the stock of a corporation is very widely distributed so that no person or small group of people has any considerable proportion the management itself is in control Either the Pennsylvania Railroad or the American Telephone and Telegraph Company is a good example The existing management may have obtained control by promoting the company originally by one time holding considerable amounts of stock, by being the successor in one of these situations or by merely having collected authority by virtue of its position Under anything like normal conditions such control is stable Stockholders either do not vote or else send their proxies to the management which has the only list of stockholders There is always the possibility of stockholders uniting and obtaining a new management but such drastic action is exceedingly unlikely This type of control exists with 44% of the companies which control 58% of the wealth

If one combines the preceding figures it becomes evident that the greater

share of large corporations are controlled by groups other than the majority of the owners One can assume the legal fiction that since stockholders can vote therefore they approve the general policies of the management or else they would obtain new officers Such an assumption may be pleasing to the person who makes it but that person is closing his eyes to the facts Before one assumes that the management always acts in the interests of the stockholders one should at least examine this segment of the personnel of the corporation with some care

Management

The term management includes primarily the directors and the higher officials The general viewpoint of these top executives is accepted by lesser officials down to the straw bosses in individual factories but as one descends the scale of officialdom the amount of agreement ordinarily becomes less The boss of half a dozen machinists may well sympathize more with the labor viewpoint than with the sentiments of the president of the company In the ensuing discussion the statements concern primarily the top executives and only to a lesser degree those lower in the managerial scale

Management is interested primarily in salary and bonus Whether any one else connected with the company makes money is not particularly important as long as the management can retain control and not force the company into bankruptcy General Motors for example has a delightful plan for enriching executives it is reputed to have made between eighty and a hundred executive millionaires in the years before 1929 but in this case the company has been so highly profitable that even the stockholders also benefited As a contrast Bethlehem Steel paid some seven million to its executives within a period of four years while the stockholders were receiving nothing

Most direct payments of large amounts to executives are in the form of bonus rather than salary The presumption is that the bonus rewards the efficiency of the recipient but the outsider tends to wonder whether any executive is really worth a million dollars a year, particularly when no dividends are paid Is not the earning of profits for the owner one of the most obvious tests of the efficiency of management? Now and then stockholders have brought court action against their officers as in the case of the American Tobacco Company but such suits are rarely effective

A prolific source of executive enrichment lies in the holding company set up which can be used to fatten salary and bonus payments Controlling a pyramided set up it is possible for the management to vote itself numerous offices each contributing its mite to the total income of the executives

Other sources of profit besides salary and bonus are not hard to find The directors might reorganize the company and issue new stock keeping much for themselves including the voting stock Some or all of them might

act as bankers and make sure that the profits of underwriting the new issues are large—such profits of course going to themselves

Directors may also use their inside knowledge to their own advantage in buying and selling the securities of the corporation Knowing in advance whether a particular report is going to be favorable or unfavorable they can buy or sell the stock as the case might be But they can easily go a step further in manipulation as using a large surplus to pay extra dividends and force the stock up—after which they sell their holdings The next dividend may be kept low so that the stock will fall after which the directors can buy considerable amounts of the stock and repeat the whole process Such manipulations have been limited within the recent past both by an improvement of business ethics and by law The S E C now publishes all stock dealings by insiders

Other possibilities are limited only by the ingenuity of the management As individuals they may buy competing plants for resale to their own company at handsome profits In the Rockefeller Stewart struggle mentioned previously the objection to Col Stewart was primarily that he had participated in a company which had bought crude oil for resale to Standard Oil at a fat advance in price—such sales only being possible because Stewart ran Standard Oil Many other cases of executives selling to their own company at a large price have existed The directors of the St Paul Railroad invested in electric power plants and sold power to the St Paul after it was electrified—of course to the advantage of themselves and not to that of the St Paul

Executive actions for their own profits may at times be illegal and at other times be of doubtful ethical propriety but they are at all times intensely human Our laws tend to catch up but slowly with current methods of making money without producing additional value for anyone else The point with which we are concerned however is that management has a point of view and a goal of its own—an end which does not necessarily run parallel with that of other groups within the corporation Again there is a struggle for power with one group winning and others losing

Labor

The one group that probably has the most to make or lose in the corporation is the force that works for wages For them the job is the difference between economic life and death Their chances of living in comfort and of rising in the world are highly dependent on the business policies and personnel of the corporation If the personnel is antagonistic the workingman may be fired or at least not advanced If the business policies of the management are mistaken the company may lose business or even go bankrupt in either of which cases many workingmen lose their means of livelihood

In spite of his tremendous interest in the management of the corporation

the worker has legally no voice in the control of the company By law he does not participate in ownership and no other rights are given legal sanction

While labor has no legal rights in the management of the corporation he may actually have a rather effective voice in particular cases Labor unions with their right to strike may win improved working conditions or higher pay, either of which may well divert funds from other interested groups The action of labor may force the adoption of a new business policy or even produce the outright bankruptcy of the business Labor does not want the business bankrupted but may adopt a mistaken policy because of its lack of confidence in the financial horrors inevitably predicted by the management Short of causing insolvency labor may be willing to take all the returns of the industry It has no real interest in bondholders stockholders or management As selfish as other groups, it tends to take everything that it can get

This conflict between management and labor has at times been reduced by more complete confidence on both sides Both are anxious for a prosperous industry, since otherwise neither one can obtain a return Various plans have been inaugurated for the common discussion of joint problems although most of such plans fail because management will not entrust labor with an accurate and detailed statement of the finances of the industry Rightly or wrongly the executives are worried on the one hand by the possibility of excessive demands by labor and on the other by information leaking to competitors

Consumers

The ultimate end of all production is theoretically to benefit the consumer—a fact that is frequently forgotten because of our great emphasis on the profit motive Undoubtedly the consumer has a large and real stake in the corporation Costly methods of production and distribution, excessive salaries and wages unnecessarily high interests and profits monopoly prices all affect the consumer adversely

The relation of the consumer to the corporation is somewhat like that of labor Although the consumer has an obviously large interest in how the business is run and what prices it charges, he has no legal rights which management is bound to respect On the other hand he has a certain amount of power in actual practice His prime club is the ability to refuse to buy where conditions are not satisfactory By this simple method he can at times force changes in the policy of management

The consumer like any other person has little concern for others He wants a good product at a low price, and is completely indifferent about interest dividends salaries and wages Consumers will stop buying if they think quality and prices are poor, but attempted boycotts because of unfair labor practices are seldom very successful, while the possibility of obtain

ing a boycott in favor of minority stockholders and their dividends is so improbable as to enter the field of humor

Government

The one agency through which all the interested parties in a corporation may act is the government Each group has money and votes both neces sary for the politician The tendency is for the government to give each group what it wants even though any single concession may be nullified by what is given to some other group Politicians are reelected by what they have done and not by what they have failed to do

Promoters bankers lawyers bondholders and their allies are fighting mainly a rear guard action designed to protect what they already have Property rights and the inviolability of contracts have been written into our Constitution and laws many years ago Interest on loans including bonds continues even though the financial heavens tremble and insolvency threatens to become universal as in the period after 1929 When a group such as labor threatens their property people with material possessions can appeal to the courts for support if the courts are insufficient state and federal troops may be requested and are sometimes granted

The bondholder is troubled by a major depression not because he fails to receive his interest for the time being but because he may be adversely affected if his business should ultimately fail When this danger appears the bondholder may hope for federal funds to buttress the enterprise The government has been receptive to this pressure and the Reconstruction Finance Corporation has advanced millions to shore up tottering financial edifices

Within recent years the stockholder has tended more and more to realize the difficulties of his position and to look to the government for some aid He would like to be assured that the securities that he buys have at least an outside chance of continuing to exist His first success was in obtaining the so called 'blue sky laws which outlawed some of the most obviously fraudulent of stock promotions Within more recent years he has obtained legislation to simplify utility holding company structures and to establish the Securities and Exchange Commission which gives some assurance that new and large flotations of securities will not be seriously misrepresented Some suits have been brought against management with the hope of per suading the courts to hold that management has a fiduciary relationship to the enterprise and its stockholders In the case of the railroads a con siderable number of stockholders have advocated that the government acquire the railroads since in this way their stock would have more value than under any other conceivable circumstances

Management is one of the groups that i defending an entrenched posi tion against encroachments It has been quite satisfied with the way things have been going and prefers above all else to avoid a change Consequently

it appeals rather paradoxically to our tradition of laissez faire with the hope that it will not be disturbed in the control that it has been able to attain It opposes any form of governmental control of its own corporations heavy taxation, increasing strength of labor more power to the consumer Of course it accepts tariffs subsidies and other governmental favors The fight for the maintenance of this conservative position has tended to be a losing one as other groups nibbled away at the powers they desired

Both labor and the consumer have been obtaining governmental action in considerable amounts but these developments will be merely mentioned here since they are discussed at greater length elsewhere in this book Labor has obtained notably the regulation of working conditions the right of collective bargaining social security legislation minimum wage and maximum hour laws The consumer has pure food law and a minimum control over advertising and utility rates and services Undoubtedly both of these groups will obtain more favors in the near future and thus decrease the freedom of action of other groups notably management

Conclusion

The corporation should then be considered as the arena of contesting forces each tending to obtain more for itself even at the expense of other groups And yet this statement leaves the story very incomplete In many ways all groups want similar things as for example they all want a prosperous corporation the only conflict comes in the question of who shall benefit the more from the prosperity

Group conflicts within the corporation are repeated to some extent on a smaller scale within each group Not all stockholders have identical interests any more than has all labor or all consumers Part of this variation represents merely the diversity of human nature but part represents a conflict within the individual A consumer is also a producer and frequently a bondholder or a stockholder A banker or a lawyer or an industrial executive has varied interests which cause him to feel different things at different times and even different things at the same time We are still waiting for the political genius who can resolve all of these conflicts to produce a more satisfactory and effective industrial system

CHAPTER 6

FINANCING THE CORPORATION

Raising the money for corporate needs is big business in itself Probably at least half of American savings go into corporate securities either as direct investments by the saver or as the investments of banks trust com panies insurance companies and other financial institutions Corporate securities have the tremendous advantage that they are more readily sale able in case of need than more tangible holdings such as land and goods

The financing of a small corporation presents no serious problem Very possibly the promoters themselves or at least they and their friends and their business associates will furnish the necessary capital so that the general public is never invited to buy If any investor then wants to sell his stock he must find a purchaser and agree on a price Likewise if any potential purchaser desires such stock he must find some owner who is willing to sell Either effort may be fairly difficult

A very high proportion of American corporations are only bought and sold privately as between individuals and never pass through any broker age house or stock exchange sometimes even a comparatively large com pany may not solicit any wide distribution of its stock With a corporation of any size however there is usually a more or less constant buying and selling of its stock even if it is not listed on a stock exchange In this event various brokerage houses will handle its issues regularly and upon request will quote an over the counter price for the securities Lists of such prices can be found in any metropolitan newspaper

Financing a Large Corporation

For the larger corporation which desires to distribute its stocks and bonds widely to the general public in order to obtain considerable capital the process is not entirely easy The obvious method would be to offer the securities in newspaper advertisements and then sell them to any applicants as long as the supply lasted This procedure is seldom used in practice The average corporation is neither a banker nor a stockbroker It has no experience and no facility in making sales of stock and bonds It has no expert knowledge of the prices at which the securities should be offered It would like the assurance that the entire issue would be sold and any particular offering might remain largely unsold thus embarrassing the company

The usual solution of a corporation s difficulties is to get the bankers to

underwrite' the issue That is, the bankers agree to pay a flat sum for the entire issue so that the company can count definitely upon its income The bankers expect that they in turn can sell these securities to investors at a somewhat higher price and thus show a profit on the transaction In case they are unsuccessful and the company then fails the bankers lose Practically all state and local government bonds and part of the industrial issues are given to the bankers making the best bids but in many industrial situations the company has its own banking affiliations to which it gives its business without competitive bids

Bankers who underwrite security issues range from very large to very small Among the larger firms one can observe Kuhn Loeb and Co Dillon Read and Co Lee Higginson and Co Even one of these financial giants may prefer not to take full responsibility for a large flotation and may collaborate with other banking houses each assuming the responsibility for part of the issue

For the underwriters to be successful in reselling securities to investors they must have connections with hundreds of smaller bond and brokerage houses throughout the country The issues may be advertised in the newspapers and magazines, and may even be sold from door to door like vacuum cleaners or brushes Many a bright college graduate of the 1920s particularly if he were a star athlete was set to realizing on his friends and fame by selling stocks and bonds The highly ethical salesman tries to fit the security to the purchaser but most salesmen are anxious above all to make sales Widows orphans and other reputedly incompetent financiers are as fair prey as more knowing and wily individuals Financial institutions and trust funds are restricted somewhat by law as to the type of investment they can make

Within recent years the investor has received some small protection by various state and federal laws An effort has been made to eliminate the completely fraudulent corporation as an incorporation of the Sir Walter Raleigh estate or of a prospective gold mine that has no property on which gold could conceivably be discovered The Securities and Exchange Commission requires an elaborate prospectus for new securities The company must present both its financial status and the purpose of the new issue in considerable detail These various restrictions by no means prevent all losing investments but they do eliminate some of the worst offenders

An interesting sidelight on the marketing of securities is the infrequency with which common stock is sold outright for cash A study made in the first three months of 1928 concerned 65 issues listed on the New York Stock Exchange They were issued in the following ways—

In reorganization	5 095 309	19%
For rights	5 732 019	21%
Exchange of stock	8 506 119	31%
For cash	1,459 642	5 4%

Most of this stock apparently went to insiders often at reduced prices or as a gift The rights to which reference is made are rights given to former security holders to buy the new issue at a cut price their value may depend in part on earnings formerly plowed back into the business Those shares representing an exchange of stock were largely increased amounts of stock given to the old holders of stocks and bonds Frequently large blocks of stock are retained by the promoters as part of their profits such was the case of United States Steel At other times stock may be given as a bonus on bonds to encourage their sale The inevitable conclusion is that a large proportion of stock represents no investment and consequently has no property back of it Its value depends on the earning capacity of the corporation If the corporation goes bankrupt the common stock is almost inevitably worthless

The widespread sale of corporation securities indicates their attractiveness to investors Some considerable share of this attractiveness is the result of the ease with which such securities can be bought and sold Many of them may be bought or sold at any time and within a few minutes The reason for this facility is that so many men have wished to buy and sell particular securities that they have organized stock exchanges for this purpose The usual large city has such an exchange and sometimes it has more than one We will consider the New York Stock Exchange since it is both the largest and typical of the rest

New York Stock Exchange

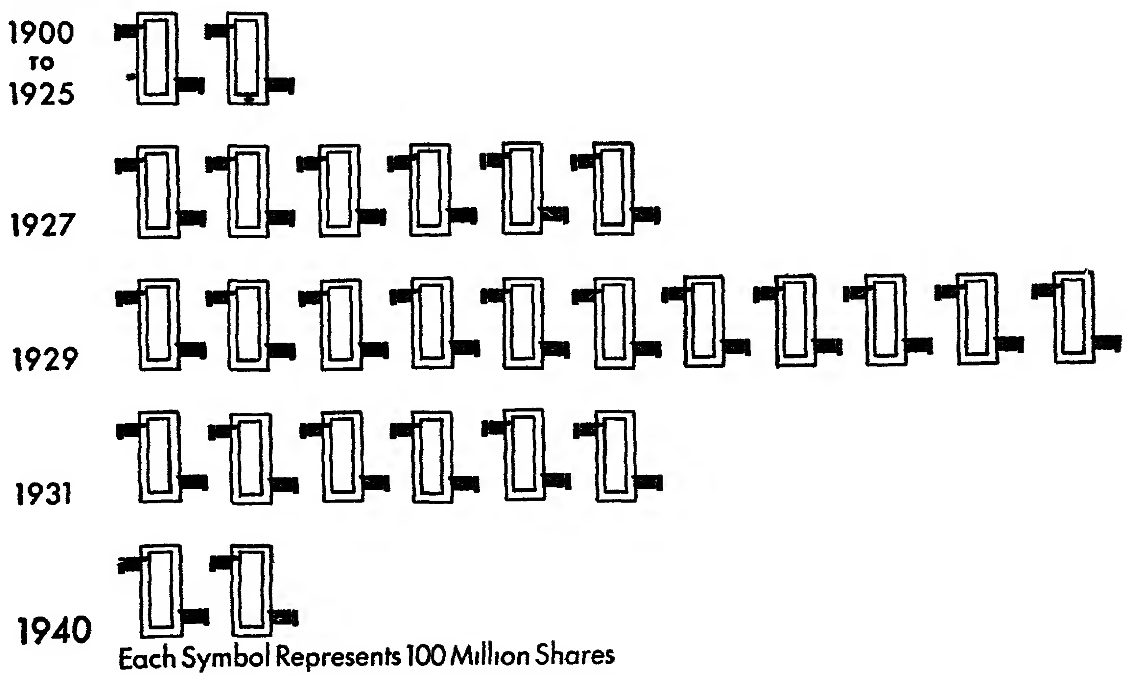
The New York Stock Exchange as any similar organization is composed of a group of men interested in the buying and selling of securities and hence in need of a common place in which to meet and transact their business The organization itself takes practically no responsibility for the securities in which members trade does no buying and selling of its own and sets no prices It merely offers facilities for the transactions of its members A stock exchange is one of the freest competitive markets in the world A considerable number of buyers and sellers meet and dicker until they complete sales The final price is one of the best illustrations of the competitive formation of price

The membership of the New York Stock Exchange is definitely limited and hence no seat is to be obtained unless a present member retires The privilege of doing business on the exchange is valuable to its possessor and consequently seats have frequently brought over $100 000 Although seats are sold privately each new member must be approved by the exchange before he is admitted the exchange is particularly interested that he be a man of probity since transactions on the exchange depend entirely on verbal commitments

There is a president of the exchange who may not operate on the floor of the exchange during his presidency He has considerable importance in the

Share Transactions on the New York Stock Exchange

Annually



running of the organization but is even more important to the public as the official representative of the exchange Very few more harmful events could occur than when a former president of the stock exchange Mr Richard Whitney was sent to Sing Sing for improper financial transactions

A board of 32 governors has general direction of the affairs of the exchange but in practice usually delegates its powers to various standing committees The Board of Governors is not composed exclusively of members of the exchange As many as fifteen can be non members although this would be unusual Three must be non members representing the public an interesting device to broaden the viewpoint of the Board The members of the Board are classified so that various types of traders are always represented

The greater part of the detailed work of the stock exchange as an organization is done by seven standing committees They are the executive committee concerned with the assets of the exchange the committee on admissions concerned not only with new members of the exchange but also with new partners of member firms the arbitration committee, to handle disputes between members the committee on floor procedure the committee on member firms which is concerned with the business conduct of member firms including their relation to the public the committee on public relations which handles exchange propaganda and supervises member advertising the committee on stock list which concerns itself with the listing and removing of securities

The size and importance of the New York Stock Exchange may be gathered from the fact that it handles some 1200 stock issues and 1500 bond issues all of which had a total value of approximately $86 billion on January 1 1936 The great number of the issues necessitates some division so that it will be physically possible for a man desiring to buy or sell a particular stock to find someone else interested in the same stock Trading posts at various points on the floor of the exchange provide this facility since on each of them is listed only a comparatively small number of stocks or bonds

Trading on the Exchange

A stock is listed on the exchange only upon application of the company that issues it The privilege of such listing is valuable to any large company since thereby the ease of flotation of the security is increased Both speculators and investors desire to be able to buy and sell their securities readily and the exchange provides such facility The exchange obviously can not list all securities that are presented to it It tries to pick the ones in which there will be many transactions It also examines and reports on the financial condition of the company and insists that the company present regular financial statements in an approved form although at the present time the examination and report by the S E C is more important

In any case there is no guarantee that the business will not lose money and fail, since such misfortunes are not within the control of any exchange or regulating agency

Various types of traders operate on he floor of the exchange but for the outside observer two general classifications seem the most important The first is the professional trader who is operating on his own account This man (frequently a firm) tries to buy stocks or bonds cheaply and sell them dearly for his own financial advantage His costs of doing business include the price of his seat on the exchange the $1 000 a year membership dues and a stock transfer tax On the other hand he has extraordinarily good facilities for obtaining knowledge and completing transactions and pays no fee to anyone on each purchase or sale Consequently he can make an acceptable profit on a large deal if the stock were to rise a quarter or even an eighth of a point

The second type of trader is the one who buys and sells upon the orders of other people and not for himself Considering this man professionally and disregarding the fact that he is usually also an investor in his own right it makes no difference to him whether prices on the exchange go up or down His interest is to buy and sell as much as possible to earn the fee that goes with each transaction Only members of the exchange can trade on the floor, and hence all transactions of non members must be handled by members The firms which do this type of business are generally called wire houses' because their orders are usually wired from their branch offices or other brokerage houses to their New York office and then tele phoned to the floor of the exchange

All trading on the floor of the exchange, with only minor exceptions is in units of a hundred shares Since many transactions are actually in odd lots there is a place for specialists who work largely with small lots of particular issues These men combine small orders until they have the proper sized units for trading

The transaction completed by a man trading on his own account is quite simple For example a trader desires to sell 1000 shares of General Electric common The last recorded sale was at $32 a share He goes to the proper place in the exchange and offers his stock at $32 Another trader agrees to buy at that price Both men note the transaction A page of the exchange also makes a note and gives it to a clerk so that it goes over the ticker tape Almost immediately it will appear on the ticker tape machines of every brokerage house in the United States that has such service The actual stock must be delivered by the end of the second day after the transaction and payment made The exchange has stringent regulations concerning the completion of transactions

Several points might be mentioned in regard to this transaction Its com pletion would probably have been slower if the seller had wanted more money for his shares or if the buyer had wanted them cheaper When

people are more anxious to buy than to sell prices naturally go up, and vice versa Also notice that there was no written agreement between the two men each accepted the other s word with complete confidence that it was good Transactions running into the millions of dollars are completed in this fashion Their notes were only aids to their memories and had no legal value One can see the necessity of honesty as between members Finally note should be taken of the functions of the exchange itself It afforded the building in which the transaction took place and the machinery by which a record was made It did not however have any influence on the transaction itself

When the transaction to be consummated on the floor of the exchange represents the order of a non member, the procedure is somewhat more complicated even though in essence it remains the same The original order is placed at a local bank or brokerage house By them it is sent to a company with a seat on the exchange This company telephones the order to its floor representative who then either acts himself or transfers the order to a specialist In any case the purchase or sale is usually completed within a comparatively few minutes and the customer so notified The brokerage house of course takes a fee for its services, and the fee is split when two concerns are involved

A customer has several options in his transaction He can buy or sell at the market," in which case he takes whatever is the current price Or he may specify a particular figure in which case the transaction is not completed until that figure is reached If he specifies a particular figure he may limit his offer in time or allow it to stand permanently until he cancels it

Speculators

People who own and trade in securities may be classified in two main groups even though there are many border line cases The first is the person who is primarily a speculator He is not interested in holding any stock for a great length of time and has but a minor interest in whatever dividends it may pay Instead he is particularly concerned with the rise and fall of stock prices He tends to buy considerable numbers of shares at a time but to hold them only briefly

Presumably the stock speculator should be something of a prophet so that he may estimate with fair accuracy the expectation of future business and profits upon which the stock market basically rises and falls Any or all stocks should rise in price with a prospective increase of business and fall with the reverse so that the stock market should act somewhat in the nature of a barometer, forecasting the coming changes in business weather

Unfortunately for the accuracy of the exchange as a business barometer, stockbrokers are anything but infallible While they have very considerable information concerning both general business conditions and the

situations of individual companies, they still can not predict the remote future with any accuracy They can hardly foresee a major flood or drought important defalcations or a major development in European politics Brick walls remain impenetrable for even the keenest vision

Brokers are also human beings subject to emotional distortions Those operating on the exchange are highly concentrated geographically and see each other a great deal Their ideas of the remaindei of the country come from a limited range of reading and from the rumors that pass in prodigious volume from person to person The exchange is not quite a glorified sewing circle but it does provide a fertile field for the spreading of rumors—some true and some false The friendly visit of an industrial executive to his banker may start a crop of rumors culminating in the forecasting of approaching financial difficulties in that business Brokers also have economic political and social prejudices The election of a particular president may cause every broker to quiver and the stock market to fall regardless of the eventual actions of the new administration The Republican nomination of Wendell Willkie for the presidency inspired the market to rise—although very briefly

This fact that brokers are human and that stocks go up or down for emotional reasons has led to many past efforts to make particular stocks act as someone wanted them to act Some men have made a regular practice of starting rumors that would raise or lower stock prices Jay Gould was a master of this practice in his day Such rumors may either be favorable or unfavorable to a particular company They may be started by the broker himself or by his friends or by a financial paper or commentators Charges have been made that financial commentators have not at times been impervious to bribery

The most obvious way of raising the price of a stock is to buy large amounts of it openly and even spectacularly Such buying which may be done either by an individual or by a group or pool creates the impression that the stock is in great demand by people who presumably know something favorable about it Hence other people feel that they too should buy, and the increased demand raises the price The same purpose may be achieved by both buying and selling a stock at the same time and in equal amounts The same impression is created by this action—that the stock is in considerable demand When the same person does both the buying and selling the process is called wash sales When different people are acting jointly to produce this effect the procedure is called ‘ matched orders

The practices described in the previous paragraph are becoming less usual partly through an improvement in business morality partly because of the increasingly stringent regulations imposed by the S E C and partly from the deterrent effects of an increased tax on all stock transfers Probably they have not been completely eliminated but their frequency has certainly been reduced

The man who desires to speculate on the stock exchange can pyramid his gains or losses by buying or selling on margin In either case he advances only part of the money for the transaction with the broker furnishing the remainder The result is that he can deal in a greater number of shares and thus increase his gain or loss as the case may be Let s say that Mr Risky has $3500 and a feeling that United States Steel is going to rise in price With United States Steel selling at 50 he can buy 70 shares and then if the stock rises to 60 he gains $700 minus the broker s commission Being anxious however to make a larger profit he buys 100 shares on margin—that is he advances his $3500 and the broker furnishes the remaining $1500 charging interest Since the broker is not a banker he in turn borrows the $1500 from the bank using Mr Risky s stock as security Now if the stock goes up ten points Mr Risky makes $1000 minus interest and broker s fees If the stock unfortunately falls in price Mr Risky of course loses money with equal rapidity In this latter event the broker would probably call for more margin —that is ask Mr Risky to increase his deposit so that there would be no conceivable risk to the broker or to the bank After all the broker is not doing the speculating and consequently is unwilling to assume any of the risk

The process of selling on margin—usually called short selling —is the reverse of the above process and is rarely used except by the professional trader The speculator in this case sells stock that he does not possess in the hope that the price will fall and that he can then buy it back at a lower rate thus completing the transaction with a profit to himself Such a sale as any sale must be accompanied by the delivery of the stock and hence the broker must furnish the stock for his client sometimes he borrows the necessary share from the account of another customer The gain or loss naturally depends on whether the stock rises or falls in price

In the case of Mr Risky mentioned above part of the financing of the transaction was done by a bank This kind of broker s loan is called call money" since it can be recalled without notice and usually although not always carries a very low interest rate so that the broker makes an additional profit on the difference in interest rates The amount of brokers loans outstanding by the New York banks is a fair index of the amount of activity of the stock market

Investors

The speculator is apparently doing a decreasing proportion of the business of the New York Stock Exchange He was tremendously disturbed by the depression of 1929 by the activities and expected activities of the Roosevelt administration and by the progress of the war in Europe Consequently a large propo tion of the recent activity of the exchange has been in response to the demand of inve tors—people who have savings to invest and who are more interested in the returns over a period of years than in

the short term rise and fall of stock prices Not that they are completely insensitive to changes in stock values but rather that long term investment possibilities are somewhat more important

The position of the investor has been none too easy within recent years even though the man with capital has several possible alternatives for the use of his funds He can buy tangible goods particularly land but recent real estate prices higher taxes and a slowing of population growth have decreased the attractiveness of this option He can put his money in the bank in a postal savings account in life insurance in government bonds in a safe deposit box or bury it in the back yard These options offer comparative security but very small return Industrial securities present somewhat more risk but a greater potential return both in dividends or interest and in the appreciation of security values

Having decided to invest in corporation securities the saver is still in great uncertainty as to the type of security and the particular company or companies He may ask advice of a business or banker friend or of a broker or hire an investment counsel ' The resulting suggestions may be good or bad depending on the judgement and interests of the person or persons consulted Any one is privileged to guess about the future Annual reports credit ratings and similar information is helpful but hardly conclusive Bookkeeping is designed to conceal as well as to reveal while the future itself remains inscrutable Most investors feel that their greatest insurance against serious trouble is to buy securities listed on a stock exchange so that they can be sold easily in case of need and to diversify their holdings so that their entire savings do not depend on the fortunes of a particular company

Once the saving soul has invested his capital his fortunes are largely in the laps of the gods He has no conceivable control of national or international events or even of the companies into which he has put his money He can wait and pray and when he has reason to fear for the fortunes of a particular company he can sell that stock and buy something else With luck he may make money even though the odds are somewhat the other way

Services of the Stock Exchange

The prime object of a stock market is to provide facilities for the buying and selling of securities and this function is fulfilled excellently Under anything like normal conditions any listed stock or bond is liquid —that is it can be transferred to cash on a moment s notice provided of course that the seller is willing to accept a price that may not be all for which he might wish The only exceptions come in periods of vast public excitement and particularly when everyone wants to sell his securities for there obviously is not sufficient currency in the United States to pay for all industrial securities There have been times when the market has either

gone up or down with such rapidity as to disorganize itself and necessitate the closing of the exchange for a few days These occasions have been rare Normally the market has been extremely effective

The exchange also has a function in the marketing of securities even though the great majority of its business concerns securities that have been on the market for a period of years The usual transaction represents merely a change in ownership and adds no funds to the business that originally issued the securities For the promoters of a company however the mere fact that they can count on a large and liquid market increases their chances of marketing any new securities In the case of United States Steel for example all the common stock went to the bankers and pro moters who presumably found this arrangement attractive because they expected that this stock would have a price and be readily salable both of which eventualities occurred General Motors was established in 1908 with a modest stock issue (common and preferred) of about $10 000 000 Further stock was then issued for use in absorbing other companies but none was offered for public subscription By 1915 the shares had a market value of about a billion dollars and at this time they were listed on the exchange and thereby distributed to the general public

In practice there are then limitations to the stock exchange as a medium for the disposal of new issues of securities Most such issues are actually sold directly to the public and not marketed through the exchange while most exchange transactions mean no additional capital either directly or indirectly for the company concerned The kind of marketing suggested in the case of General Motors merely provided a large profit for some one other than the company Indirectly the exchange has some advantage in providing a liquid market which increased the salability of industrial securities by providing an excellent medium for their resale An active market certainly makes the distribution of new securities more easy as in the lush days of the 1920s when as many as 16 000 000 shares changed hands in the five hours of a single stock exchange day

There has been some feeling that the services of the stock market in the disposal of securities are not at all necessary The favorite illustration is the Ford Company which has never listed its issues No company is entirely typical, but neither is Ford completely unusual In the early days the sale of Ford securities on a large scale would have been impossible because of the novel nature of the undertaking Once the business had succeeded sales would have been easy but by that time new capital was not needed This corporation has been somewhat unusual in the size of its reserves so that it has been able to take care of poor years additions, changes and replacements from its savings

The contention has even been made that the stock market actually decreases the capital available for industry by diverting it to speculative purposes Banks look with favor on brokers loans because of their liquidity

and will use their money in this fashion if they have any choice This argument is probably not very important since the amount of available credit has usually been greater than the quantity that has been used and since there is little proof that the credit going into brokers loans would ever be available for ordinary industrial uses

Stock speculation may have some effects either in causing security prices to fluctuate dangerously or in making all prices rise Rapid speculative rises and declines in stock prices may frighten the more cautious investor from putting his money into industrial securities As to the other point there is some doubt as to whether stock prices influence other prices in any important fashion Even the boom market of the late 1920s was not accompanied by any notable price increases in commodities On the other hand however stock speculation may have prevented a desirable fall in prices

The operations of the stock market and particularly the activities of the speculators, have at times been credited with the stabilization of stock prices Theoretically when the market is too high the professionals should sell and when it is low they should buy thus tending to keep prices at a proper level In practice there seems to be little support for this contention With a rapidly rising market both the professionals and the amateurs accept the prevailing enthusiasm and buy to the top of their bent On the reverse swing they all try to sell The probable effect is that stock market operations tend to exaggerate all movements both up and down

Not only should stock market operations tend to keep prices at a reasonable level for all stocks but it should tend to evaluate individual securities to keep them in line with the total market A good stock at a low price should be bought by the professionals until it attains a proper relationship to other stocks while the reverse should also be the case In consequence capital should flow into the more profitable channels and returns should be equalized on comparable stocks Whether or not such a result has occurred is a matter of opinion Illustrations can be given both ways Certainly all stocks both good and bad tend to go up and down with the least fluctuations in the better shares and most in the more speculative Whether this situation indicates any evening of stocks by speculators is at least doubtful

Mention has already been made of the function of the stock exchange as a barometer of business conditions Many illustrations can be given of the stock market rising just before a business upswing and descending just before a downswing but there is some question as to which is cause and which is effect—maybe the tail wags the dog at least upon occasion Presumably the business man reads the daily newspaper and when he sees stocks sinking rapidly and steadily he may well become fearful of approaching troubles and curtail his operations This lessening of production immediately shows in the current statistics with the result that the market again falls Probably neither general business conditions nor

the stock market need take entire responsibility for a change in the rate of business activity Due to their close interrelationships they affect each other

Conclusion

Stock exchanges have very real and important functions in any modern and capitalistic civilization As long as the funds for the establishment and expansion of business come from thousands of small investors there will be need for a market place in which such securities can be bought and sold And yet a stock exchange is a convenience rather than a necessity and its importance should not be overemphasized The recent tendency to eliminate some of the more flagrant of the bad practices of the past and to make the exchange primarily a place where brokers execute orders for investors is undoubtedly wholesome

PART III

The Price Mechanism

CHAPTER 7

THE NATURE OF THE PRICE MECHANISM

All economic systems have the same general purpose to satisfy the wants of the people living under them For this purpose any economic system requires an organization for the production distribution and consumption of goods and services

Production

Production may be defined as the creation of utilities that have value By utility is meant the power of a good or service to satisfy a human want For any good or service to have value it must be scarce in relation to the demand for it Since goods are not fully produced until they are in the hands of the final consumer the production process involves the creation of form place time and possession utilities People engaged in manufacturing farming and mining are creating form utilities—that is they are changing commodities into forms that will give greater satisfactions to human beings For example automobile plants transform steel, glass rubber and other commodities into automobiles No one section attempts to produce all the goods necessary for the satisfaction of the wants of its people Each section specializes in certain commodities and exchanges them for the commodities produced in other areas The agencies engaged in transferring goods through space are creating place utilities Certain goods for various reasons satisfy more important wants at one season of the year than at another To meet these needs such agencies as warehouses and cold storage plants create time utilities The local retail store performs a similar function It has its various supplies on hand so that the customer is able to buy at the time he wants the goods The retailer is also one of a series of dealers called middlemen who creates possession utilities that is he aids in the exchange of goods to persons to whom they will give greater satisfactions

The creation of form place, time and possession utilities is therefore, necessary before the production process is completed Each of these types of utilities may be created by a separate group or two or more may be created by one group The more highly specialized the economic society the more likely it is that there will be a separate performance of the functions but in any case the function must be performed Moreover this holds true as much for a socialistic a communistic, or a cooperative society as for the ones usually termed capitalistic

In any type of economic system there are four factors involved in the productive processes—labor natural resources capital, and entrepreneurship Any country blessed with great natural resources such as fertile land, rich mineral deposits and plentiful water power in proportion to its population is in a favorable position to achieve a high degree of productive efficiency To develop these resources a sufficient supply of skilled and efficient workers is necessary But the results from labor applied directly to natural resources will be meager Capital goods in the form of machinery plant, railroads electric transmission lines, and in a myriad other forms are necessary for the production of the goods required to satisfy the wants of the people of modern society Such capital equipment can only come from the savings out of past and present production Any society that continuously consumes as much as it produces will soon find its capital equipment deteriorating This may be obviated for a time by borrowing from outside the country but eventually saving must take place The savings resulting in a fund of carrying power make it possible for a portion of the labor of a country to engage in roundabout production that is in making a machine that will eventually make consumption goods—goods for the satisfaction of the wants of individuals The final factor necessary in the production process is entrepreneurship—the factor that assumes the responsibility for economic activities This assumption of responsibility involves both making the ultimate decisions concerning what shall be produced and bearing the first line risks of industry The entrepreneurial function may be performed by an individual partnership or corporation in a country like the United States or by the state in an economic system like that of the Soviet Union, but just as any economic system to continue must save and accumulate capital some persons, groups or group must assume the function of responsibility taking

Under any economic system decisions must be made as to how the factors of production are to be allocated among their various possible uses Under no system is it sufficient to decide that chairs shirts, pork chops, airplanes, and so on shall be produced The problem is how many of the thousands of goods and services shall be turned out? In addition in some way decisions must be made concerning what proportion of society's resources shall be allotted to military preparedness to education, and to health services Not even the wealthiest society has sufficient resources to produce as much of everything as the people of the society could use Therefore, the resources must be economized and put to those uses to which the allocating mechanism of the particular society directs them

Distribution

In every economic system the goods and services produced must be divided among the people living under it For the maintenance of capital equipment it is necessary that a certain portion of the annual income be

saved and invested in production goods in the form of plant, machinery and the like Every state as such performs certain services for its citizens and to make this possible the state must secure a certain portion of the annual income through taxation or other sources of revenue And certainly the individual citizens must secure enough of the product to maintain at least a minimum of subsistence

There is a twofold aspect to the problem of distribution—functional and personal Functional distribution represents the division of the annual income into wages to labor rent to natural resources interest to capital and profits to entrepreneurship Under personal distribution come the individual citizens shares of the total income

Where private ownership of capital and private assumption of responsibility taking exist a functional return of interest to capital and of profits to entrepreneurship is necessary both to insure incentive and to secure proper allocation of these productive factors Individuals and corporations will not accumulate and invest capital in sufficient amounts unless there is a probability of securing a return on it and assuming the same degree of risks to secure its investment in particular fields the possibility of securing a higher rate of return than elsewhere must exist Entrepreneurs must also see the possibility of profits before they will assume responsibility taking, and varying rates of profits largely determine the lines of activity that entrepreneurs will enter While the general supply of land and other natural resources is not dependent on the receipt of rent, nevertheless differences in rent are necessary to secure the allotment of these resources to particular uses Neither is there any correlation between the general supply of labor and wage rates if wages are above the minimum of subsistence, but differentials in wages are necessary to provide an inducement for laborers to acquire the desired skill and to enter particular occupations

Even in a socialistic economy like that of the Soviet Union the problem of functional distribution exists Wages is the only distributive share privately received and the Soviet Union maintains differences in wages both for incentive and for allocation of workers While interest rent, and profits are not paid out to private individuals, nevertheless they are items in the cost of production just as they are in a capitalistic country like the United States If land capital and responsibility taking are allotted to the production of dams power plants canals and to the heavy industries they cannot be used immediately in the production of consumption goods and in consequence a cost is involved in the form of a lower current standard of living

There are three possible standards of personal distribution—equal according to need and according to productive efficiency Any economic system must consider the effects of its system of personal distribution on both productive efficiency and on consumption Stark equality in distribution would likely have undesirable effects on both It would give no

monetary incentive to the acquirement of greater skill or efficiency, and it would certainly hamper the proper allocation of the factors of production among their various uses Nor is there any reason to believe that the greatest welfare would be achieved if every individual had the same command over consumption goods If the needs of different individuals could be determined with any degree of accuracy distribution based on the principle From each according to his ability to each according to his needs would be most desirable in the field of consumption But this principle would probably have just as bad effects on productive efficiency as would the principle of equality Again there would be insufficient incentive to acquire skill and there would be difficulty in securing a proper allocation of the productive factors

Distribution based on efficiency or productivity is the principle in operation in all countries today even though it may be modified to a greater or less extent In those countries where most industries are privately owned and operated distribution in the main is according to the monetary value productivity of the individual as laborer or entrepreneur or to the monetary value productivity of his land and capital This value is determined by the relative demand for and supply of the particular factor s product In the greatly different economy of the Soviet Union the productivity principle is also in operation in determining the recompense to labor the only factor of production from which individuals as such secure a reward Here productivity is measured by the ability to carry out the plans drafted by the leaders of the Communist Party The advantage of distribution according to efficiency lies in its tendency to lead toward greater skill and productiveness and to its allocation of the productive factors according to the wishes of the dominant group in a particular society Its chief weakness comes from the fact that it necessarily leads to inequality of income thereby reducing the total satisfactions derived from consumption To counterbalance this weakness, every society today through state action modifies distribution according to efficiency By means of progressive taxation funds are secured from the more wealthy to be used in the provision of education, health and recreational services and the like for the poorer members of the society In this way the efficiency principle is modified by the need principle

Consumption

The total consumption in any society depends upon the amounts and kinds of goods and services produced The amounts consumed by the individuals and families constituting that society depend upon the size of the incomes received by them Consumption standards thus depend upon both the total amount of production and the distribution of the nation s income

To approach anything like ideal consumption purchasing power must be

so divided that no additional satisfaction could be derived by a shift of purchasing power from one individual to another and in addition each individual must so apportion his purchasing power that he could derive no greater satisfaction by shifting his purchases from one commodity to another To achieve this standard of ideal consumption would require a considerable reduction in economic inequality in most all societies As an offset a drastic equalization of incomes might lead to less productive efficiency and thereby reduce the total amount of goods to be consumed To achieve the second part of this ideal standard requires that consumers have full knowledge concerning what goods and services will give them the greatest satisfactions and also requires that they have complete qualifications for judging the various goods offered on the market

The Price System Its General Operation

Every important economic system today operates under some sort of price system In the United States the price system serves in the main to determine what and how much of the various commodities shall be produced how the output shall be divided among the factors responsible for its production and among the individuals supplying the productive factors and what shall be consumed by the various individuals constituting our society The price system thus serves to register the same sort of decisions that would be made if there were an authoritative planning board which ordered the various goods to be produced in specific quantities decided how the total of goods and services should be divided among the citizens of the country and directed consumption habits

The operation of the price system is sometimes described as automatic in contrast to decisions that would consciously be made by a planning board with such great authority as that just described The price system is automatic in the sense that it has no one guiding and directing authority but it is most decidedly not automatic in the sense that it operates on its own momentum uninfluenced by human judgment and will The chief difference between the economic decisions made under the operation of the price system in a capitalistic country like the United States and those made in a country like the Soviet Union by the State Planning Commission is that in the United States the scope of the planning is much more narrowly limited In the Soviet Union the Planning Board makes general comprehensive plans which determine what shall be produced and in what quantities and which depend to but a limited extent on the desires of individual consumers In the United States consumers make decisions as to their expenditures in relation to their incomes and the prices of the various goods These decisions are of course largely influenced by the customs and spending habits of the consumer s circle of acquaintances and by the advertising appeals of producers But however they are made the sum total of these many individual decisions affect the decisions as to what

shall be produced On the producers side, the scope and importance of the decisions made depend upon the size of the business unit The scope of the decisions of the small farmer retailer and manufacturer is very limited He may decide that he will grow wheat run a grocery store, or manufacture skirts but he has very little control over the prices he pays for labor and for supplies or over the prices he will receive for his product Even less does the individual laborer or small investor have control over the wages he will receive or the return upon his investment

On the other hand the scope of the decisions made by giant corporations like United States Steel General Motors and American Telephone and Telegraph extends over a much wider area Since such concerns produce such a large proportion of the goods and services in their respective fields of operation their decisions have a considerable influence on the prices of the materials they use on the wages paid to their laborers and on the prices they receive for their goods and services But even the decisions of these companies affect directly only their own particular lines of operations Decisions by General Motors only indirectly affect decisions by the American Telephone and Telegraph Company

Economic decisions made by government, particularly by the Federal Government are of even wider scope The services rendered by government, the prices charged for certain of these services, the taxes collected and the regulations enforced oftentimes overlap various segments of economic activity and effect most economic decisions made by producers and consumers But in a government functioning with the degree of democracy existing in the United States these governmental decisions are largely determined by the relative strength of the various pressure groups If protective tariffs are established it is because certain manufacturers wish to be sheltered from foreign competition If payments are made to farmers to increase their purchasing power it is because of the influence of the farm bloc If legislation sets up standards of minimum wages and maximum hours it is because organized labor demands such a program Thus far therefore state interference with economic activities in the United States has not represented attempts to plan the whole scope of economic relationships but only to affect the operation of the economic system in the interests of particular groups

The system of prices existing in the United States is thus a combination of competitive prices established by the activities of many small producers and consumers of monopolistic semi monopolistic, and administered prices established by the giant business organizations and of prices either set by government or greatly influenced by governmental action This, of course is an over simplified statement of the situation, for there is a lack of flexibility in most competitive prices there is no monopolistic price which is not affected by other prices and governmentally fixed prices influence the competitive and monopolistic prices

Price and the Rationing of Consumption Goods

Despite the great increase in productive efficiency during the past century or so consumption goods are still not turned out in sufficient quantities so that the wants of everybody for all types of goods can be satisfied It is therefore necessary that they be rationed in some fashion In most countries today this rationing is accomplished in the main by the price system The relative supply of and demand for particular goods on the market determine their price This is true whether such goods are produced under highly competitive conditions or by a monopolist In the one case no single producer has sufficient control over supply so that by manipulating it he can greatly influence price In the case of monopoly the producer can manipulate the supply so that the price of his good will be set at the most profitable point

Those goods of which there is a relatively small supply and for which there is a relatively great demand will have a high price Conversely a large supply relative to the demand will cause a low price The sum total of the supply and demand for a particular good determines its price but to the individual consumer the price which has been determined is the one that he must pay or go without the good His demand along with that of thousands of other consumers has helped to determine the price but the amount of the good that an individual buyer will take is largely fixed by the price Whether for example the consumer will pay six dollars for a pair of shoes is determined by the relative intensity of his desire for the shoes in comparison with his desire for other commodities This relative intensity is based on the number of shoes he now has in comparison with other commodities which he might buy for six dollars and upon the number of dollars he has

In practically all cases individual buyers stand ready to take more of a particular commodity at a lower price than at a higher price For example if shirts of a particular grade at a certain time are selling for $2 buyers at the store may take fifty if the price should be lowered to $1 50 buyers would tend to take more possibly seventy five Larger sales at lower prices and fewer sales at higher prices are based on (1) the limited number of dollars possessed by most consumers and (2) the decreasing satisfactions derived from additional units of the same commodity The first of these reasons needs no explanations and the second is experienced by each of us every day To use the illustration of the shirts again to one wishing to retain his position in respectable society one shirt at least is essential, and for it a very high price would be paid if necessary a second shirt is almost equally important but later additions to one s shirt supplies become of less and less importance and, therefore for them buyers stand ready to offer less money

While the demand for a particular good is nearly always greater at a

low price nevertheless there is a difference in the degree to which the demand for the various goods expands or contracts with changes in price Demand is said to be elastic when it expands or contracts a great deal with a change in price It is inelastic when a price change brings small expansion or contraction in demand To give simple illustrations

Elastic Demand

Price	$1 00	$ 50	$ 25
Buyers will take	1 000	2 500	6 000

Inelastic Demand

Price	$1 00	$ 50	$ 25
Buyers will take	1 000	1 200	1 600

It will be noticed that in the case of elastic demand the amounts that could be sold multiplied by the price gives a larger total at the lower prices the reverse is true where the demand is inelastic From this however it must not be concluded that the low price policy in the case of elastic demand is always best for the producer The cost of production of additional units would have to be known

Price therefore serves to divide existing consumption goods among the members of society Goods selling for very high prices can only be enjoyed by the rich those with small incomes can purchase relatively few goods Those above the bare minimum of subsistence make decisions as to how they will spend their purchasing power to secure the greatest enjoyment Shall two dollars be spent for a book or for gasoline? Such decisions to be made are numerous and they are largely made on the basis of price If certain goods become scarce their prices rise and some consumers can no longer enjoy them If other goods become more plentiful there is a tendency for their prices to fall and more consumers buy them The price system thus operates to divide goods among consumers with some degree of efficiency the justice of its rationing is more questionable

Price as the Determinant of Production

In addition to serving as the device for rationing among consumers the goods already in existence the price mechanism in a country like the United States is the principal determinant of future production Price movements report to entrepreneurs whether there should be a greater production of skis or of bathing suits a smaller production of phonographs or pianos If for example at the current price of $2 the demand for a certain commodity exceeds its supply, the price will tend to rise If the price reaches $2 50, let us say, there will very likely be a larger margin of profit between the cost of production and the sales price This larger margin of profit will serve as an incentive for greater production of this commodity former producers will strive to expand their output, and probably new producers will enter the field A fall in the price of a com

modity will have the opposite effect Profit margins will be reduced and probably for some producers will be wiped out entirely Output will be decreased both by some producers leaving the field and by others curtailing production

It is thus seen that it is desirable that the prices of commodities for which the demand exceeds the supply at a particular price should rise and should fall in cases where at a particular price supply exceeds demand Without this rise or fall in price there would be no effective indicator of what should be produced in greater and what in less amounts It must be remembered that demand and supply are always relative to a particular price A simple example of demand and supply schedules will illustrate this point

Demand	*Price*	*Supply*
1 000	$9	9 000
2 000	8	8 000
3 000	7	7 000
4 000	6	6 000
5 000	5	5 000
6 000	4	4 000
7 000	3	3 000
8 000	2	2 000
9 000	1	1 000

This simple illustration shows that buyers stand ready to take more of a commodity at lower prices and less at higher prices and that suppliers stand ready to furnish more at higher prices and less at lower prices In this illustration an equilibrium between demand and supply is reached at the price of $5 Now let us assume that because of a change in consumer habits brought about by social fad advertising or other reason the buyers stand ready to take more at all the various prices say 2 000 at $9 3 000 at $8 4 000 at $7 5 000 at $6 6 000 at $5 and so on If the supply still remained as before with suppliers standing ready to supply 5 000 at $5 and 6 000 at $6 the immediate result would be for the price to settle somewhere between $5 and $6 the exact price depending upon the relative bargaining strength of buyers and sellers But according to the schedule given suppliers will furnish more at a higher price and soon a new equilibrium point will be reached at which demand and supply will again equate This price we can assume to be at about $5 50 We thus see that a real change in the demand schedule has brought about a nominal change in the supply schedule In other words buyers standing ready to take more of the commodity at all the various prices caused a higher price this higher price in turn caused suppliers to put more goods on the market It is equally true that a real change in the supply schedule would have caused a change in price and in turn a nominal change in the demand schedule

Sometimes there may occur simultaneously a real change in both the

demand and supply schedules Such simultaneous changes may offset each other and cause little or no change in price on the other hand they may at times cause a more drastic change in price than if there had been a real change in only demand or supply The low price of bootleg whiskey in a southern state around 1931 illustrates the accentuation of price changes by the simultaneous real changes in demand and supply Because of the depression buyers had less purchasing power and there was a real decrease in demand for whiskey Also becau e of the unemployment arising from the depression more people began illicit distilling giving rise to a real increase in supply of whiskey The joint forces caused the price to fall to an extremely low level

To put the interactions of demand, supply and price on each other in a general statement price is determined by the relative demand for and supply of a commodity a price change can only occur because of a real change in the demand for or supply of a commodity, a real increase in demand or a real decrease in supply will cause a higher price a real de crease in demand or a real increase in supply will cause a lower price If the higher price is caused by a real increase in demand this higher price will tend to bring about a nominal increase in supply if the higher price is caused by a real decrease in supply it will tend to cause a nominal decrease in demand if a lower price is caused by a real decrease in demand the lower price will tend to cause a nominal decrease in supply if a lower price is caused by a real increase in supply, the lower price will tend to cause a nominal increase in demand In any case price serves to direct consumer purchases and acts as an indicator of what goods and in what amounts it is profitable for producers to supply And it must be emphasized that this relationship among demand supply and prices is the same whether competitive monopolistic or the various types of administered prices are being considered

Price and the Allocation of the Factors of Production

The price mechanism also serves to allocate the factors of production—labor land capital and entrepreneurship—among their various possible uses That is it serves to direct labor into particular occupations, land and capital into particular industries and entrepreneurship into particular lines of production If at the present or prospective price of a particulai good entrepreneurs see the likelihood of gain, they will enter upon the production of that good To produce that good labor, land, and capital are required and to secure these factors the entrepreneur must bid a high enough price in the form of wages, interest, and rent to attract labor land and capital From the economic point of view if the factors of production are properly allocated, the return to factors of the same quality must be the same in all possible uses That is labor is not properly allocated if laborers with the same degree of skill are receiving $6 a day in one occupa

tion and $4 a day in another If the price mechanism is working properly labor will be attracted from the $4 use to the $6 use thus leading to a similar return in both uses The same line of reasoning is applicable to the allocation of the other productive factors

Wages interest rent and profits are simply specific types of prices wages the price paid for the services of labor interest the price paid for the services of capital rent the price paid for the services of land and profits the price paid for the services of entrepreneurship As has been shown earlier it is the function of entrepreneurship to decide what direction production shall take and it is the entrepreneur that makes the payments to the other factors engaged in the productive process As an incentive to individuals or groups of individuals organized in the corporate form of business enterprise to perform the functions of entrepreneurship the possibility of recompense in the form of profits must be present If there is not the possibility of profits the services of entrepreneurs will not be forthcoming in sufficiently large amounts to organize the production of the goods desired by consumers

Differentials in the size of profits are necessary for the purpose of directing entrepreneurs into the different lines of productive activities Because of rising prices of commodities for which there is an increase in demand profits will tend to be larger for entrepreneurs engaged in their production The larger profits will encourage the entrepreneurs engaged in the production of these types of goods to expand output and will likely bring new entrepreneurs into these fields To encourage entrepreneurs to engage in new and risky enterprises the possibility of profits must be larger than in the old well established enterprises Under a price system where industry is privately owned and operated profits are thus necessary as the price paid to furnish incentive for a sufficient supply of entrepreneurship and to allocate entrepreneurship among its possible uses

The price system having furnished the incentive for entrepreneurship and having served to allocate it among its various uses, the entrepreneurs must pay prices to secure the services of the other productive factors Wages the price paid for the services of labor have little if anything to do with the total potential supply of labor Except for that portion of the population living at the bare minimum of subsistence level higher wages will have no effect in causing more children to reach the working ages, and in the case of those at the minimum of subsistence higher wages will not cause more births but will have their effect in a lower death rate The general trend is for the birth rate to vary inversely with the size of the family income But while the general wage level does not greatly influence the general supply of labor relative wages among the various occupations do tremendously affect the division of labor among the various industries It must be noted that the payments to the factors of production are both

rewards for their services and means of causing the factors to do certain things

The different wages offered by the several entrepreneurs in a capitalistic system are the chief means for causing laborers to acquire certain skills and to enter particular occupations And this is also true in socialistic Soviet Russia In fact the only other general means for allocating labor is authority This does not mean that in any society there are not many people who choose their work for idealistic reasons—to advance social welfare and the like that there are not others who choose their work because it is the type they like when they might earn more elsewhere that hours of work and the permanency of the job affect the attractiveness of different occupations But up to the present at least none of these other motivations affect anything like the number that is influenced by wage differentials and it may even be pointed out that such factors as hours and permanency are really pecuniary motivations Therefore under the price system when prices of certain commodities rise entrepreneurs see the possibility of greater profits they offer higher wages to lure workers to these industries Conversely in other industries, prices of commodities and profits may be falling and entrepreneurs offer lower wages thus reducing the incentive for new workers to enter these industries and possibly causing old workers to seek employment elsewhere

The bidding of entrepreneurs for capital affects both the supply and allocation of capital As has been shown already, the supply of capital results from saving from not spending all of present income for immediately consumable goods Most people will tend to save more if they receive a higher price for their savings in the form of a relatively high interest rate than they will if the interest rate is lower In most cases a 6% rate will provide greater inducement for saving than will a 3% rate Undoubtedly there are exceptions to this but it seems a fair statement of a general trend Likewise a higher rate of interest will provide an incentive to invest capital in a particular industry In a profitable industry entrepreneurs will offer a relatively high rate of return on capital in a less profitable industry the rate offered will be lower While it may not be possible to shift old capital, the new supplies will seek the more profitable and shun the less profitable fields of investment It may seem contrary to this statement that new and risky enterprises may have difficulty in securing capital although they may offer high rates of return while safe enterprises may secure large supplies of capital while paying but low returns But the difference in return is due to the difference in payment for risk taking and not in the payment for the use of capital alone, and risk taking is a function of entrepreneurship rather than of capital The high rate of return offered by the risky enterprise is a combination of both interest and prospective profits with the latter constituting the bulk of the promised return

The price mechanism has nothing to do with the total supply of land but it does allocate land among its various possible uses When entrepreneurs foresee a chance for profits in any particular undertaking they must pay a price for land that will attract it from other uses in the same way that they must bid to secure labor and capital Suppose for example that a piece of land near a city has been used as a truck farm The city is growing and an entrepreneur decides that the truck farm will make a profitable real estate development To secure the land he must pay more than its value as a truck garden In turn tenants on the real estate development must pay sufficiently high rentals to justify the outlay of the entrepreneur Similar illustrations could be used to show how differences in rent earned in growing cotton or tobacco in furnishing a site for the Waldorf Astoria or the Empire State Building will cause a particular piece of land to be used for one purpose rather than another

It must be emphasized again that decisions concerning the rationing of goods among consumers concerning how much of particular commodities shall be produced and the returns to the various factors of production must be made in any type of economic society It is desirable that any society use its resources goods and services economically This means that sparing use should be made of those that are relatively carce and freer use of those that are relatively plentiful The price system tends to produce this economical use by relative demand and supply establishing a high price for scarce goods and resources and a low price for those which are plentiful Moreover it is only within relatively narrow limits that there can be interference with the prices set by the existing demand and supply or demand and supply will be thrown out of adjustment For example attempts to fix interest rates below or above the equilibrium point between the demand and supply of capital will either prove impossible to enforce or if enforced will cause a less supply of capital than is demanded in the one case or a greater supply in the other If in the laudable desire to provide housing for poorer people at low rates rentals charged by private realtors are drastically reduced by legal enactment the supply of houses will tend to become smaller If minimum wage laws establish wages appreciably above current rates the probability is that unemployment will result It is only when the monopolist restricts supply that monopoly price can be higher than competitive price would have been

Under any economic system based on the private ownership and operation of the means of production the costs of the entrepreneur which include a profit in payment for his own services cannot long continue to be above the sales price of his product If his costs in terms of wages interest and rent rise he must be able to shift the higher costs in the form of higher prices paid by the purchasers of his products This can usually be done only by restricting output and to produce a smaller output fewer factors of production are needed This does not mean, of course that rising wages

are impossible Increased labor efficiency makes the payment of higher wages possible without any necessity for raising prices to prevent a loss to the entrepreneur But if the prevailing prices truly represent an equilibrium between demand and supply for a particular good, service, or factor of production interferences with these prices will set in motion forces that will seriously disarrange the working of the economy It is on this basis that the case for a laissez faire economic system rests and the next section will discuss the operation of a competitive price system

CHAPTER 8

COMPETITIVE AND MONOPOLISTIC PRICES

The Competitive Price System

Adam Smith the father of modern economic literature in his *Wealth of Nations* published in 1776 contended that if individuals were left alone to seek their economic interests that while they would be working directly for their own gain nevertheless as if led by an invisible hand indirectly their activities would produce the maximum of wealth for the nation It was on the basis of this belief that the general principles of laissez faire developed These general principles may be summarized as follows every individual wishes to increase his own wealth every individual is a better judge than is anyone else as to what use of his own labor capital and land is the most profitable the wealth of a nation is the aggregate of the wealth of its citizens the wealth of the nation will thus increase most rapidly if every individual is free to look after his own economic interests competition among producers will prevent the exploitation of either laborers or consumers for to secure employees the business man must pay wages high enough and provide working conditions good enough to attract laborers from other employers, and similarly, to make sales he must supply goods of sufficiently high quality and at sufficiently low prices to attract customers from other sellers therefore in pursuing his own gain every producer is promoting the interests of every one else It will be noted that the theory of laissez faire assumes that in general economic activities will be carried on under conditions of free competition

Under the complete operation of these principles all production distribution and consumption would be determined by competitive market price What would be produced and how much of the various commodities the amount of capital accumulated and its allocation the allocation of labor, land and entrepreneurship the amounts paid for the services of the various productive factors and the division of consumption goods among the various individuals—all these would be decided by competition operating through market price

Basic to such an individualistic, competitive order are the following institutions private property in the means of production freedom of enterprise freedom of contract freedom of exchange Emphasis on these several individual freedoms however should not lead to the belief that

free competition is synonymous with anarchy Under anarchism there would be no compulsory government while to maintain and enforce private property rights freedom of enterprise freedom of contract and freedom of exchange government is necessary The theory of laissez faire objects to governmental interference with individual economic activity because such interference is held to injure both individual and general welfare but it holds it to be the duty of government to protect the institutions which make free competition possible Adam Smith and later proponents of laissez faire specified that the state must furnish protection to private property against external attack and internal disorder that it must enforce contracts that it must provide a sound medium of exchange and that the state should engage in certain undertakings like the provision of lighthouses that would not prove profitable to individuals But in general the state should refrain from direct economic activity for unregulated individual performance of such activities is held to be most efficient and beneficial for all concerned

While a complete system of laissez faire has never and probably could never be put into operation nevertheless as long as almost all American economic activity was carried on by relatively small producing units competition in the main furnished the guiding directing and coordinating forces in our economic life Even in this period monopolies such as inns and toll roads and toll bridges existed but in general the small farmer merchant, manufacturer and the like in his search for profits produced those things which the consumer through the medium of market price showed that he wanted No one producer turned out a sufficiently large proportion of the total output so that he could very greatly control consumer demand either through his advertising or manipulation of price Prices were flexible and very sensitive to both changing demand and changing supply If any one producer attempted to exploit consumers either by reducing quality or by charging prices that were much higher than cost of production it was reasonably certain that competition by other producers of the same commodity would serve as a protection to the consumers If the prices charged by all the existing producers were so high that an unusually high rate of profit was being earned it was relatively easy for new enterprisers to enter that field, for the amount of capital required to enter business was not large

Since the great majority of business enterprises were of relatively small size, they were owned and managed by the same person or small groups of persons Gains therefore, came to the owner managers from the sale of the output of the plant and not from stock manipulation The businesses were operated for the economic interests of the owners but since they were relatively small, the bargaining power of the buyers and sellers were approximately equal With this approximation to equal bargaining power between buyer and seller and with reasonably free competition among

sellers and buyers resulting in flexible prices the price mechanism served as a fairly accurate indicator of what commodities should be produced and in what quantities If a more efficient technique for manufacturing a certain commodity was introduced by a producer his resulting lower costs made it possible for him to undersell his competitors To protect themselves the competitors had to find ways of lowering their costs the improvement thus resulted in lower prices to buyers If consumer demand for a certain commodity increased its price rose This higher price served as an incentive for a number of producers to increase output and their rivalry for sales kept the price from rising as much as if there had been a monopolistic element in the control of supply

Since most productive units were small the individual producer rarely had a commanding influence in determining the price he would pay for the use of the productive factors Conversely few suppliers had a sufficient control over capital or land to be able to determine the prices charged for their use Moreover wages were a fairly accurate expression of the monetary value productivity of laborers that is of the maximum amount they were worth to their employers The number of workers hired by any one firm was usually so small that the workers enjoyed fairly equal bargaining power with their employers and the competition of employers for workers and of workers for jobs made the wage rates established in the market reasonably good indicators for the allocation of labor

Thus, under the conditions of small scale production competition operated fairly well Most individuals could determine what economic activity was to their own best interests within limits individuals had the choice of entering the line of economic activity where their interest lay no one set of entrepreneurs land owners capitalists or laborers was sufficiently powerful to set prices since prices were to a large extent determined by competition and relatively equal bargaining power among the different groups existed prices were flexible and served as a reasonably good determinant of production, distribution and consumption

Limitations on the Operation of the Competitive Price System

But in pointing out that in the days of small scale production competition worked reasonably well we must not look at this period with nostalgic eyes through rose colored glasses There were always factors which prevented the competitive system from working as well or as accurately as was posited by pure theory

In the first place the belief in the economic man—in the individual who absolutely knows his own best economic interests and is only motivated by the pursuit of these economic interests is erroneous At no time can an individual know absolutely what line of economic activity will bring him the largest economic return Moreover if he did know at one particular period economic activity is too uncertain for one to be sure that for any

long time a particular line of investment or a particular occupation will lead to the greatest economic benefit And even if one could be certain that a particular productive activity would bring the greatest economic return over a lifetime in many cases it would not be chosen The appeal of a particular activity idealism, the desire for social esteem social mores and folkways and other influences often are of greater weight in determining one s economic pursuits than is the desire for or the probability of the greatest economic return

But supposing each individual was aware of his best economic interests and was solely motivated by the desire for economic reward it is not true that he is in a position to pursue his economic interests completely effectively If we assume that consumers know what they need lack of knowledge concerning goods, and even more lack of purchasing power often prevent them from securing the desired goods No consumer can have the expert knowledge to assure him that a commodity is of the type and quality that he is seeking This ignorance upsets that perfect balance between the bargaining powers of the seller and buyer predicated by the theory of laissez faire Market price as an indicator of what should be produced is even more disturbed by the inequality of income which existed to about the same extent in the days when large scale productive units were largely non existent as it does today Goods and services will not be produced merely because there is a need or want for them There must be a demand for them and for a want to be transformed into a demand purchasing power must be present Unequal incomes mean that certain individuals can exert a demand for the most unessential of luxuries a larger number can only enter the market for the bare necessities Since under the price system only those things will be produced the sales price of which will cover all costs including profits to the entrepreneur, this inequality in consumer demand will cause luxuries for the wealthy few to be produced when if the real wealth of nations was being sought necessities and comforts for the poorer groups should receive priority The analogy of a political election is sometimes used to describe the way in which production is determined by consumer demand Consumer purchases are said to represent the votes of the electorate The analogy would be more accurate if certain voters were empowered to cast several hundred thousand or even several million times as many votes as some others Inequality in income thus prevents market price from being a true indicator of what should be produced for, contrary to the theory of laissez faire, each individual consumer cannot pursue his interest effectively when his purchasing power is small

The theory of laissez faire presupposes in addition to complete knowledge of one s economic interests and complete motivation by one s economic interests the possibility that each factor of production can be allocated where it will bring the greatest return This theory is based on the assump

tion of perfect mobility of the factors of production that is that each factor can be shifted from an industry of low return to one of higher return and that this shifting process continues until the return is the same in all fields of production It is apparent of course that there are two types of mobility involved in this shifting process—geographical and occupational For perfect mobility to exist it must be possible for the factors of production to be shifted from one area to another and from one economic use to another To what extent does this perfect mobility exist?

It is undoubtedly true that when deciding upon entrance into business entrepreneurs tend to go into those fields that promise the greatest profits But after they are once committed to a particular industry changes can only be made within relatively narrow limits Entrepreneurs formerly engaged in the manufacture of wagons could with some difficulty shift their enterprises to the production of automobiles when the profits from wagons fell and from automobiles rose They could not very well shift to the production of radios shirts or beer When it appeared likely that more profits could be made in textile manufacturing in the southern states than in New England there was a gradual shift in the location of that industry But the shift has taken considerable time Older entrepreneurs could not immediately transfer their activities It is therefore clear that for the most active of the factors the one that is possibly in the best position to pursue its economic interests mobility is by no means perfect

Invested capital is no more easily shifted to uses that bring greater return than is entrepreneurship After capital has been invested in particular types of machinery in a particular locality it is difficult to shift it to some other use or to some other region Machinery can of course be shipped, but oftentimes great expense would be involved Within limits machinery which has been employed in manufacturing one commodity may be used in the production of something else but in general after there has been capital investment in a particular line of enterprise the investment cannot be withdrawn It must either continue operation in this field or lie idle For this reason a firm may continue production even though the sales price of its output does not cover all costs for greater loss may be incurred by ceasing operation

Land of course, has no geographical mobility, but it may be transferred from one use to another However even the transfer of this sort may be limited Good cotton land may not produce tobacco very well Suburban land cannot economically be used for the erection of skyscrapers Furthermore, after land has been put into one use it takes time for it to be shifted to some other use After a farm has been sown to cotton it will be another year before it can be transferred to tobacco and by the time the change takes place tobacco production may not be so profitable as it was a year earlier In 1929 it seemed economically worth while for the Empire State

Building to replace the old Waldorf Astoria Hotel By the time the change took place its profitability was questionable

Labor has probably less mobility than any of the other factors It would seem that geographically it is the most mobile but its easier physical mobility is offset by human attachments to certain localities It makes no difference to a machine where it is used but home ties family obligations and the like may prevent a laborer from moving elsewhere even though he knew that he could earn more in some other locality More important however than geographical immobility is occupational immobility The knowledge that a skilled machinist earns high wages can have but little effect on the choice of jobs of an unskilled worker Due to some innate difficulty or to lack of opportunity most unskilled workers cannot become expert machinists Even more difficult would it be to enter the professions Moreover it is almost impossible for the skilled or professional worker to transfer to some other trade or profession After a particular training has been acquired the worker must stay in the field even though higher earnings might be obtained elsewhere

Mobility of the factors of production therefore does not exist to the extent posited by the premises of laissez faire Rising or falling prices cannot automatically and immediately bring about greater or less supplies of a particular commodity It is of course not necessary that all of the factors be immediately mobile for the desired equilibrium to be brought about A shifting of a relatively small proportion of entrepreneurship capital land and labor from the less profitable to the more profitable uses could bring the desired results but in many cases even the small proportion does not have the necessary mobility The shifting must usually wait for new entrepreneurs new supplies of capital and the oncoming generations of laborers to spurn less profitable uses and to enter the more remunerative fields And this naturally involves a time lag in the proper allocation of the productive factors

Effect of Large Scale Production on the Competitive Price System

Lack of knowledge of one s economic interests other motivations than the pursuit of one s economic interests, and lack of mobility of the factors of production have thus at least hampered the operation of the theoretical system of laissez faire by preventing perfect competition and equal bargaining power in the economic system Furthermore, perfect competition is to a large extent dependent upon the existence of a number of relatively small firms operating in a particular line of enterprise But the development of modern technology while leading to greater productive efficiency required large amounts of capital for its introduction Naturally in but few cases did the individual proprietor or even the partnership possess sufficient capital to install the new expensive machinery Therefore, despite

Adam Smith s belief that the corporate form of enterprise was suitable only for such businesses as banking insurance canals and waterworks the corporation with its facilities for accumulating capital from thousands of widely scattered investors has become prevalent in many lines of enter prise There could of course be as much competition among many small corporations as among many small non incorporated business enterprises but in those industries where the production processes were easily reducible to routine performance and where the product could be standardized the advantages of large scale production were apparent Furthermore the great improvements in communication and transportation made possible nation wide even world wide markets for such commodities Large scale produc tion for wide markets in many cases lowered unit cost of production since the overhead costs of plant and equipment could be shared by a vast number of units of output Furthermore the large scale productive units enjoyed the advantages connected with the use of more highly specialized machinery and labor A small plant could not find it profitable to have an expensive machine engaged in a minute part of the productive process or to have its labor force engaged in highly specialized tasks To the large plant such specialization brought further economies The lower unit cost of production enjoyed by the large plants in many industries made it possible for them to drive their smaller competitors from the field and in a number of cases a tendency toward monopoly appeared

In the great attention paid to the development of large scale enterprise and to the tendency toward monopoly there is a danger, however, that the continuance of small scale production units in many types of enterprises will be overlooked In this connection the conclusions drawn by The Twentieth Century Fund s study *Big Business Its Growth and Its Place* are well worth quoting at length [1]

The picture can be painted in two sharply contrasting colors For example taking the broadest view it can be truthfully said that 81 per cent of all Amer ican economic activity is carried on by medium or small corporations by firms which are not incorporated at all or by individuals More than two fifths of the entire business activity of the United States is not in corporate hands at all—much less in the grip of the giants Of the total national income produced the corporations with $50 million or more assets produced only 18 4 per cent in 1933 From this point of view the large corporation sinks into relative insig nificance

By concentrating attention only on that particular 57 per cent of our eco nomic life which is carried on by corporations it can just as truthfully be said that 584 corporations out of the 504 080 that existed in the United States in 1933—or one tenth of 1 per cent—own more than half the assets of all cor porations put together or to put it another way 95 per cent of all corporations in the United States own slightly more than 14 per cent of all the corporate

[1] A. L Bernheim (Ed) (New York 1937) pp 98 99

assets This sounds as if American business were completely dominated by big business And such is a very common opinion

Yet this is just as ' colored a picture as the other Both pictures are true at the same time and both must be kept in mind if the realities are to be firmly grasped

To break these figures down further In 1933 omitting the economic activity of the government, the giant corporations with assets of fifty million dollars or more produced 20% of the national income corporations with assets of between one and fifty million dollars produced 20% while unincorporated firms and corporations with assets of less than one million dollars were responsible for the production of 60% of the national income [2]

The size of the production units varies widely among the different industries In agriculture only 6% of the total income is produced by corporations in construction only one third of the income is produced by corporations and the fifty million dollars and over concerns possess only 2 7% of the industry s total assets in the manufacture of women's clothing the six largest concerns employ but 3 7% of that industry s total workers Likewise in the planing mill furniture men's clothing cotton textiles silk paper, canning and other industries the individual firms are small

At the other extreme 1 2% of the largest public utility corporations own 83 9% of the assets in these industries in mining 2% of the firms control 35 2% of the assets the eight largest cigarette manufacturing concerns employ 99 4% of all workers in the industry and in the manufacture of typewriters, sewing machines explosives matches, motor vehicles motion pictures aluminum products, agricultural implements and other products a relatively small number of large firms hold a predominant place [3]

These widely differing conditions within the various industries greatly affect the principles of price determination Where the small production unit is typical prices are more nearly determined by competition in the manner already discussed In the industries dominated by giant corporations, prices are more likely to be semi monopolistically or administratively determined These types of price determination will now be discussed

Monopoly Price

While there are very few absolute monopolies except those based on some governmental franchise [4] nevertheless the principles of monopoly price determination and the economic and social effects of monopoly price must be considered in order to understand the functioning of the price

[2] *Op cit* pp 96 97
[3] *Op cit* pp 99 100 and chart 3
[4] These usually have their prices governmentally regulated Such prices will be discussed later

system Monopoly may mean the unified control over either the sale or purchase of a commodity but for the purposes of this discussion the treatment of monopoly will be limited to the unified control over sales

A monopolistic seller just as a seller in a competitive market is desirous of securing the price for his product that will bring him the greatest net return But unlike the competitive producer the monopolist can control the price that he will receive through the adjustment of the supply of the commodity placed on the market The competitive producer must accept the price fixed in the market the monopolist can set the market price for his good But it is absolutely necessary to understand that if this price is set at a higher point than competitive price would have been there must be a restriction in supply for buyers will take fewer units at the higher price Let us suppose that there has been competitive production of men s straw hats Demand is such that 600 000 can be sold at $6 800 000 at $5 and 1 000 000 at $4 Under competitive conditions suppliers have put 1,000 000 on the market at $4 and at this point the price has been estab lished Now suppose one concern secures a monopoly in the production of straw hats If it still puts 1 000 000 on the market, demand remaining the same it can only receive $4 per hat If our monopoly fixes the price at $5 only 800 000 can be sold and there will be a surplus of 200 000 hats

In determining the price that will bring the greatest net return the monopolist must take into consideration both the nature of his unit cost of production and the nature of the demand for his product If additional units of output can be produced only at increasing unit cost restriction of supply will take place earlier than if additional units can be produced at a lower unit cost If the demand for the product is elastic it will tend to be less profitable to restrict output and charge a higher price than in cases where the demand is inelastic This is true because where the de mand is elastic there will be a great shrinkage in demand at the higher prices where the demand is inelastic, the shrinkage in demand at a higher price will be much less Monopolistic price is therefore, likely to be considerably higher than the competitive price would have been where there is an inelastic demand for the good and where the production of additional units involves a higher cost per unit Monopolistic price will more closely approach competitive price and in some cases might actu ally be lower if the demand for the good is very elastic and additional units can be produced at a decreasing unit cost of production But in any case the monopolist will be adjusting supply so that a price can be charged that will bring the greatest net return

This brief statement of the principles of monopoly price determination shows that the widely held opinion that a monopolist can charge any price that he wants is incorrect—at least if the monopolist has any inter est in the amount of his sales and the size of his gains Monopolists may set prices where they please, but the higher the prices the less consumers

will buy and less gain may result from a high price than from a lower price policy

There are certain factors which often prevent or deter a monopolist from actually setting his price at the point that will bring the greatest net return The monopolist does not possess perfect knowledge of his cost schedules and more especially of his customers demand schedules This ignorance may cause the price set to be either above or below the one that would bring the greatest net return In addition fear of potential competition or of governmental regulation may deter him from charging what seems like an excessively high price If it becomes known or suspected that at prices charged a monopolist is reaping very great gains there is always the possibility that some daring entrepreneur will attempt to invade the monopolist s domain And a governmental anti monopoly crusade is always to be feared While the crusade may not be effective in breaking up the monopoly nevertheless it will be expensive to combat Therefore the wise monopolist is usually content to fix a price somewhat lower than the one that would immediately bring the greatest net return

Discriminating Monopoly

Since in practically all cases there are more buyers ready to buy a commodity at a lower price than at a higher price a monopolist can make more gain if he can charge different buyers different prices That is if in our illustration of the straw hats the monopolist could sell 200 000 at $8, 200 000 at $7, 200 000 at $6 200 000 at $5 and 200 000 at $4 he would make more gain than if he sold 1,000 000 at $4 800 000 at $5 and so on Now in the case of a good like a straw hat it would probably be impossible to divide up the market in such a desirable fashion But where the customer can be led to believe that there is a real difference between the articles discrimination in price takes place which far exceeds any difference in cost involved in making the slightly different articles This can be illustrated by different editions of a book by different grades of soap by the difference between night and day rates for telegraph and telephone service Of the same book a publisher may print a limited de luxe edition selling at a very high price per copy an ordinary fabric bound edition selling for $3, and a paper bound edition selling for $1 Each will tap a different section of the demand for the book, and the several prices will bring a greater return than if there had been a uniform edition and a uniform price The soap manufacturer by varying the perfume the wrapper and the name can sell the same soap at different prices The telegraph and telephone companies can stimulate additional use of their services by the lower charges at night In these and other ways monopolists avoid a uniform price and through discriminatory prices are able to secure a greater net return from the sale of their products

Objections to Monopoly

Monopolies are often defended on the ground that they are more efficient producers than are competitive industries It is contended that they secure the advantages of large scale production that they can avoid over duplication of productive facilities and that they can more accurately adjust production to consumer demand For certain industries like those commonly designated public utilities such claims are probably well founded but from any viewpoint other than that of the monopolists themselves these contentions for other industries are not usually sound In most industries the advantages of large scale production can be realized by the moderate sized competing firms as a matter of fact actual efficiency in production may be less in the giant concern than in the smaller producing unit The prevention of over duplication of productive equipment and the better adjustment of production to consumer demand usually means the restriction of output for the purpose of securing a higher price than could be charged if there were competition This restriction of output leads both to excessive profits for the monopolist and to a bad use of society s productive resources If by restricting production the monopolist prevents productive resources from entering his particular field the resources must be used elsewhere In the other use their return will be less and thus there has been a bad allocation of society s limited resources If the restriction of output involves a cessation of the use of resources already invested in the monopolistic industry the loss is even greater for the resources will be producing nothing at all The excessive profits earned by the monopolist aggravate still further the inequality of wealth opportunity, and power and thus weaken still more the validity of price as the rationer of consumption goods and as the director of what should be produced

CHAPTER 9

ADMINISTERED PRICES—BY PRIVATE ORGANIZATIONS AND BY GOVERNMENT

Monopolistic Competition

It has been shown earlier that there are relatively few prices that are determined either under conditions of perfect competition or of perfect monopoly Most prices are affected by both competitive and monopolistic elements, and naturally in the formation of some prices the competitive elements are stronger and in others monopolistic influences play a more important part As new techniques have been introduced into many lines of enterprise the old role played by competition has tended to become smaller The introduction of the new technique in the form of machines often requires a tremendous capital investment This requirement of large capital limits the number of firms in the particular field Competition among the four, six or eight giants in the particular industry continues but it is a different type of competition from that existing where many small industries are in operation

It will be remembered that where competition among many small producers exists, no one producer is in a position to fix the price Each producer receives the current market price for his good which has been determined by the relative demand and supply for his product His own supply is usually too infinitesimal a portion of the total supply to have much effect on the price if it is withdrawn from the market Prices set in such a competitive market are very flexible varying as the relations between the demand for and the supply of the particular product vary

But where competition exists only among a few giant concerns prices are no longer of this at least semi automatic flexible nature The industrial giant sets its price and adjusts its supply to the price rather than the price having resulted from the interplay of supply and demand on each other For example General Motors Ford, and Chrysler dominate the manufacture of automobiles Each company after estimating the costs of producing its various types of cars and the probable demand for each at various prices sets its prices These prices usually remain the same throughout the current year, even though the demand for automobiles at these prices may prove to be greater or less than had been estimated The same situation exists in the production of iron and steel, farm machinery typewriters and many other goods Prices of these goods are not set by

the automatic forces of supply and demand in the market they are administered that is they are directly based on the judgment of the company officials Of course, these officials cannot set both the price and the amount that will be sold at the administered price But if the estimated number cannot be sold at the price set the volume of production will be reduced The administered price remains inflexible, the flexibility is in the amount supplied

This difference in the degree of flexibility of prices and of output between industries composed in the main of a few large firms and those of a large number of small producers is shown strikingly in the following table[1]

Decline in Prices and in Production—1929 to Spring of 1933	*Per Cent Drop in Wholesale Prices*	*Per Cent Drop in Production*
Agricultural implements	15	80
Motor vehicles	16	80
Cement	18	65
Iron and steel	20	83
Automobile tires	33	70
Textile products	45	30
Food products	49	14
Leather	50	20
Petroleum	56	20
Agricultural commodities	63	6

The officials of the giant corporations who administer the price and production policies are faced with the problem of deciding whether it will be more profitable or involve less loss during a period of declining demand to reduce prices and maintain output or to maintain prices and reduce output If prices are reduced and output maintained the overhead per unit cost of production is lowered if prices are maintained and output lowered the direct out of pocket cost of labor and raw materials is reduced In making this decision the officials cannot be certain how much more of the product can be sold at a lower price Because of this uncertainty they usually decide that it is better business policy to maintain prices even though this involves lower sales than to gamble on the results of a lower price policy Furthermore they are strengthened in this decision by the fact that maintaining production prevents a reduction in the direct out of pocket expenses for labor and materials In a period of declining business it is essential that costs be reduced As has been seen the lower direct costs may be more than counterbalanced by increased overhead cost per unit of product when production is lowered But for a rela

[1] C F Ware and G C Means *The Modern Economy in Action* (Harcourt Brace and Company New York 1936) p 24 Also see *Senate Document* 13 74th Congress 1st sess 1935

tively short period these overhead expenses may in large part be treated as accounting costs rather than as real outlays The capital has already been invested and the depreciation account may be reduced for a time Over a period of several years the overhead costs are of course just as real as are the direct costs but for a time they can be neglected The difference in the urgency of meeting the two types of costs, therefore is an important influence in causing the officials to reach the decision that it is better business policy to maintain prices by restricting output

Result of Monopolistic Competition

The competition among a few giant corporations with their policy of administered prices has quite different results than the competition among many small producers whose prices are determined by the automatic operation of the forces of supply and demand In the first place even though during periods of prosperity all the existing large concerns may be making great gains it is next to impossible for a new concern to invade the field The entrance of a new firm may require the initial investment of scores or even hundreds of millions of dollars Under this new type of competition the old rule of the game that large gains will attract new competitors is for this reason extremely slow in operation if it operates at all Nor do the administered prices function to drive less efficient firms from the field during a period of falling demand Under the older type of competition falling demand usually meant a reduction in the price of a product At the lower prices some of the less efficient firms went out of business Competition thus led to the survival of the fittest and in the main to increased economic efficiency

Under competition based on administered prices there is far less likelihood of an inefficient firm going out of business It is quite likely true that none of the firms is covering costs both direct and overhead when production has been reduced to 20 or 30 per cent of capacity But the loss may not be so great as if the firm entirely ceased production So long as anything above direct out of pocket expenses is earned by operating at a fraction of capacity output it is good business to do so rather than to close down And even if the giant business should go bankrupt in the interests of its creditors it is likely to continue operation under a receivership rather than go out of business Where many millions of dollars have been invested competition simply does not operate to force an inefficient firm out of business as it does in the case of small retail stores or shirt factories

The successful functioning of an economic system based on private enterprise presupposes a high degree of flexibility in the various parts of the system Prices are supposed to move freely so that they may serve to indicate what shall be produced and in what quantities Mobility of the factors of production is assumed for if the production of commodities is

to vary in proportion to varying prices it is necessary that the productive factors shift easily from one use to another Any influence therefore, creating rigidities in such an economic system interferes with its efficient functioning Such rigidities arise from the mal functioning of the money and banking system, certain labor union practices disturbances in international trade badly conceived and badly administered governmental policies monopolistic and administered prices and the like All of these interferences at times play their part in creating the maladjustments which cause the swings of the business cycle

Inflexible monopolistic and administered prices are thus one of the causes of variations in business activity but it is a great oversimplification of the problem to contend that these sticky prices are *the* cause of the downward swings The argument runs that the policy of price maintenance necessitates restriction of output restriction of output causes unemployment unemployed workers lack purchasing power lack of purchasing power reduces demand for other commodities and economic activities continue to fall in a downward spiral

As has been shown above these sticky prices can be considered at the most as only one of a number of possible causes of maladjustment that cause the downward spiral to begin It is in fact *after* the downward spiral has begun that the administered prices have their worst results It is after demand has started to fall that the company officials must decide whether to lower prices and maintain output or to maintain prices and lower output The bad effects of administered prices are thus more important in aggravating and continuing the downward spiral than in initiating it These bad effects are however not to be dismissed lightly Let us consider them under two suppositions (1) that during the downward spiral the demand for the good with the sticky price is inelastic (2) that the demand for it is elastic

If the demand in inelastic there will be relatively little reduction in the purchase of the commodity even though its price is maintained and even though incomes in general are falling This means that purchasers are spending a larger proportion of their shrinking incomes for this particular product leaving them with less to spend on other goods and services The brunt of declining business is thus thrown on other industries particularly on those whose prices are flexible Lack of purchasing power with which to buy the products of these other industries causes their prices to fall further than if there had been no industries with administered prices and thus the maladjustments are increased

If the demand for the product is elastic the sticky administered prices can only be maintained by a rather sharp curtailment of production This curtailment of production causes unemployment and loss of purchasing power The unemployed workers can no longer buy as much of the product of other industries, and again those industries with flexible prices are

most affected. Since most of the industries with the sticky administered prices are engaged in the production of capital goods or durable consumption goods like automobiles, the assumption of elastic demand is more likely to be true than the assumption of inelastic demand. During declining business activity firms naturally retrench in their purchases of new machinery and other capital goods, and consumers can postpone the purchase of automobiles, electric refrigerators, and the like. Sticky prices naturally cause this decline in purchases to be increased. Consequently the industries producing capital goods and durable consumption goods have a much higher percentage of unemployment during depression periods than do the consumption goods industries. But the results of this unemployment are felt by the other industries in the form of loss of sales, loss of profits, lower wages, and bankruptcies.

Trade Associations and Price Leadership

Monopolistic competition and sticky prices are also engendered by the activities of trade associations and by the "price leadership" usually instituted by the most powerful firm in an industry. Trade associations are organizations of the firms engaged in a particular industry. Their openly declared functions are: to carry on research, to maintain good public relations for the industry, to secure information concerning the credit standing of buyers, to standardize accounting practices, and to furnish information to members concerning the productive capacity, inventories, unfilled orders, and selling prices existing in the industry. Legally, they are not supposed to determine the price and production policies of individual members. But in some cases the activities of the associations pass beyond the legal borderline, and the price and production information is used to influence the individual firms to restrict production so that a certain price may be maintained. This price maintenance prevents the most efficient firms from lowering their sales price in line with their lower costs of production, thus causing higher prices to consumers and serving as a shelter to inefficient firms.

Price leadership is usually instituted in industries where the overhead costs of production are high in relation to direct out-of-pocket costs. There is, for example, evidence of price leadership in such industries as steel, oil refining, anthracite coal, cement, and sugar. The largest firm in the industry announces its prices and the smaller firms more or less consistently follow. Thus a "live and let live" policy is pursued. The larger firm makes no attempt to undersell the smaller ones, and the smaller ones make no use of price competition to cut in on the price leader. The results of price leadership approach more closely monopoly price than competitive price. Output is restricted, there is idle capacity in the industry, and there is no lowering of price to drive less efficient firms from the industry.

In no type of monopolistic competition whether it be in an industry where there are several large firms of approximately the same size as in automobile production in an industry where price and production policies are at least affected by the activities of trade associations or in an industry where price leadership exists can prices be maintained as effectively as if one firm enjoyed a complete monopoly If the prices being maintained bring high gains in each of the above cases there is a temptation for one or more firms to expand output and make more sales This possibility of expansion of output thus makes the administered price structure less secure than if one firm controlled the whole output of the industry But on the other hand monopolistic competition is even farther removed from free and all sided competition Prices are not determined by the free interplay of demand and supply on the market new investment cannot easily come into the industry following the lure of higher gains nor will all the productive capacity in the industry be employed even though the added product could be sold at a price that covered costs and the maintenance of higher than competitive price makes it possible for relatively inefficient firms to continue production This situation is therefore quite contradictory to the assumptions of a competitive economic order

"Administered Prices" Established by Labor Unions

In addition to interferences with competitive prices by the semimonopolistic policies of business men, the competitive price system is further modified by the sticky wages that certain types of labor unions establish The theory of laissez faire assumes that wages will be determined through the competition of employers for laborers and the competition of laborers for jobs This theory further assumes perfect bargaining power between employers and employees which will insure that laborers will secure as recompense the exact amount of their value productivity As business units grew larger however the bargaining power of individual laborers grew smaller One laborer more or less to a large corporation became of little importance and the assumptions of laissez faire became less tenable To strengthen the bargaining power of laborers trade unions were organized The usual union adopts the policy of extending membership to all who work in a particular trade or industry and thus has no monopolistic restraints on membership Such unions through collective bargaining can much more nearly secure wage rates for their members which coincide with their value productivity In other words such unions tend to give that equal bargaining power which the theory of laissez faire assumes

There are however, some so called closed unions in which membership is restricted by excessive initiation fees excessive apprenticeship requirements and the like Frequently such unions have closed shop agreements

with their employers under which no non union member can be employed In a situation of this sort it is apparent that the union can establish 'administered wages which in principle are very similar to the adminis tered prices discussed earlier By restricting the number of workers in the industry wages are kept at a higher point than would have been estab lished under competition These higher wages cause a higher price for the product which is burdensome on consumers The restrictions on union membership prevent other workers from entering the industry to secure the higher wages and the higher prices of products, resulting from the higher wages by reducing sales often cause idleness among the union members The results of administered wages are thus the same as those of administered prices higher than competitive price bad allocation of the productive factors, and idle capacity in the sheltered industry or wage group

Fixation and Regulation of Prices by Government

Price Policies of Governmental Enterprises

In connection with the various enterprises operated by government different price policies are adopted In some the monopolistic principle of charging the price that will bring the greatest net return is employed in others the price is set at a point that will supposedly just cover costs which include a fair return on investment in still others the government furnishes goods or services at less than cost or free of charge the costs being met from taxes or other sources of revenue

The monopolistic principle is adopted when a government operates an enterprise for the primary purpose of securing revenue Examples of such undertakings are tobacco and match monopolies in certain foreign coun tries, liquor monopolies in certain American states and the distribution of electrical current by some local communities in the United States In the operation of these monopolistic industries governments must consider the same factors that affect the profitability of a private monopoly They must consider the effect on sales of higher or lower prices and the effect on costs of smaller or larger production Just as in the case of private monopolists inelastic demand for the product will enable the govern mental monopoly to maintain prices without greatly curtailing sales and when governments carry on enterprises primarily as sources of revenue they usually are in industries the demand for whose product is inelastic Also just as in the case of private monopoly the prices charged by such governmental enterprises are usually higher than if the goods had been sold under competitive conditions

Naturally the revenues collected by the government through these monopolistic sales come in somewhat different proportions from various sections of its citizens than if such revenues had come from taxation The

revenues from the governmental enterprises come from the buyers of the goods Revenues from high prices charged for tobacco and liquor may be defended on the grounds that these are luxuries large profits derived from the sale of electrical current are less easily defended Some southern towns collect about as much from the sale of current as from taxes Such a policy rather inequitably makes the consumption of electrical current as important a criterion as tax paying capacity for raising revenue to meet the town s expenditures

The prices charged by such governmentally operated industries as post offices railroads telegraph telephone and the production of electrical power are usually set at a point estimated to cover costs Competitive enterprise in such industries is usually inefficient and costly and govern ments often decide that the services produced are too important for the general welfare to permit the operation of such industries as private monopolies The prices set by such governmental undertakings are influ enced by the nature of the demand for the service and by the conditions of cost of production just as would be true if the industries were privately owned—provided that the private operators were satisfied with a return which simply covered costs The governmentally operated industry must determine to what extent lower prices will bring forth an added demand and equally important what effect on costs will be produced by satisfy ing the additional demand

The problems connected with the determination of costs are not simple For example what proportion of the postal overhead expenses should be allocated to the different classes of mail and to the parcel post service? In the case of railroads what part of the total costs should be allotted to freight service and what to passenger service? And to complicate the problem manifold innumerable types of freight must be considered in making up the rate schedules If these different types of cost are not determined with a fair degree of accuracy some users of the services will be getting them at less than cost and are thus being subsidized by pur chasers of other types of services if the industry as a whole is covering its costs If the whole industry is run at a loss its deficits must be met from tax receipts or other sources of governmental revenue

The problem of setting prices to cover costs becomes more difficult when a governmental undertaking like the T V A is being considered Prices for electrical current produced by the T V A are set up as a yard stick to measure the fairness of prices charged by private utilities Which costs of T V A should be met by its power output? The T V A is a multiple purpose organization Its activities include navigation improve ment flood control prevention of soil erosion and national defense as well as power production What percentage of the total costs should be assessed to a kilowatt hour of electricity?

Other types of goods and services furnished by governmental agencies

are considered of such prime economic and social importance that either the prices charged for them are purposely set too low to cover their full costs or in most cases no direct charge is levied at all Among these services are police and fire protection education, health and recreational services streets and highways In providing these services the price mechanism determines their costs of production just as if they were furnished by private gain seeking enterprises Governments must buy materials for their school buildings fire fighting equipment and for the construction of roads, and the prices for these materials are determined in the same way as if these supplies had been bought by private firms Likewise, governments must pay wages to their employees the rates of which are largely determined by the general demand for and supply of the particular type of labor Greater prestige in governmental employment and greater security of tenure may make it possible for governments to secure employees at slightly less than the market rate but if government wages are set much below the market rate there is a great likelihood that many employees will be lured away by private firms

The volume and quality of these services furnished by government to its citizens without direct monetary payment are also largely dependent on the general operation of the price mechanism Revenues to meet the costs of these services must in the main come from taxes Taxes often affect the prices of goods and even the profitability of private enterprise There is thus a limit to which government can furnish goods and services without direct payment—the limit being reached when taxes are so high that they actually act as a damper to private enterprise This is not to imply of course, that better education health services and the like do not tend to increase the productivity of a country but in any country at a particular time there is some limit to the amount of free services which can be furnished by the government

Governmental Regulations Which Affect Prices

To Enforce Competition

It has always been a part of the American tradition that, in the main economic activities should be carried on under competitive conditions—that in a particular industry prices should be determined by bargaining between freely competing buyers on the one side and freely competing sellers on the other The rise of large scale productive units led in many industries to the supersession of competitive price determination by at least semi monopolistic price controls In the attempt to maintain the American tradition most states and the Federal Government have enacted legislation for the prevention of monopoly and the enforcement of competition These anti trust laws[2] have represented efforts by government

[2] To be discussed in a later chapter

to maintain the principles of laissez faire which is evidence that laissez faire cannot be a self enforcing automatic system Moreover even supported by governmental controls it has proved difficult if not impossible to enforce competition in a number of industries In part this has been due to poorly drawn legislation to lax administration of the anti trust laws and to adverse judicial interpretation of the laws In greater part however the failure to maintain competition in a number of industries either by its automatic functioning or by legislation has been due to developments in technology leading to the economies of mass production and to gain seeking as the motivating force in industry In some industries more gain can be secured through monopolistic practices than through competitive enterprise In such industries it is doubtful whether even the best drawn anti trust laws ably administered and broadly interpreted by the courts can enforce competitive prices

To Regulate Monopoly Prices

Despite the American tradition of reliance on competition for price determination it has long been recognized that in some industries competition is wasteful and in some unworkable This is likely to be true where fixed investment is quite large in proportion to variable expenses and more especially where duplication of investment instead of furnishing better service would actually create less efficient service Among such industries are railroads telegraph and telephone service, the production and marketing of electrical power and similar enterprises The heavy capital investment necessary for the creation of such services prevents more than one company from being in operation in most areas Where there are two or more firms providing the same service the resulting competition is likely to be of a severe and cut throat nature The rate wars of the 1870s among the railroad lines operating between the Atlantic seaboard and mid western cities are illustrative of this type of competition Rates were cut to a point where they would bring in just enough revenue to meet the direct out of pocket costs of handling the traffic Within a period of eighteen months the rate on first class freight between Chicago and New York was cut from $1 to 15 cents a hundredweight Naturally when one road cut its rates, the other lines had to follow The result was that all approached bankruptcy To protect themselves against cut throat competition the roads turned to rate agreements traffic pools and similar measures But now in their monopolistic agreements the roads charged excessive and discriminatory prices for their services

Competition among the other so called industries affected with a public interest has had a somewhat similar history Private monopoly with its tendency to charge greater than competitive price has appeared after competition has proved undesirable or unworkable The state and federal governments have decided that the services and prices of such in

dustries are too important to the general public to permit unregulated private monopoly to control them, and beginning with the Granger legis lation of the mid western states and the Federal Interstate Commerce Act of 1887 there has been enacted legislation embodying increasingly stringent controls of the rates and services of the public utilities

The general principles on which governmental regulation of public utilities are based are that the consuming public shall receive adequate service at reasonable prices and that the utilities shall be allowed to earn a fair return on investment Detailed definition of adequate service reasonable prices and fair return is usually lacking but the decisions of the various regulating commissions and the reviewing courts imply that reasonable price means cost of producing the service and that in provid ing adequate service the utilities must provide each customer as much as he will buy at this price Fair return on investment is in general held to mean approximately the same return that competitive enterprises are earning In other words if the current rate of return on investments in competitive enterprise is 6%, the fair return to a utility must include 6% return on investment after all other costs have been met

The rate cases coming before the regulatory commissions are usually presented by the utilities themselves but consumers of the services may bring complaints, and the commissions themselves may initiate hearings In any case however utility rates are much more inflexible than are the prices of commodities or services produced by industries where a greater degree of competition exists Not very often does the utility itself suggest that rates should be lowered and its petition for higher rates may occur at a time of generally falling prices For example in the early years of the depression beginning in 1929 the railroads asked for and were granted higher freight rates Their argument was sound that at the existing rates they could not cover costs because of decreased shipments but lower rates rather than higher would have been a better remedy for the situa tion Lower rates would have tended to increase freight traffic thus bring ing greater revenue But whether a rate case is brought before the com mission by a utility by the consumers of its services, or is initiated by the commission itself the hearing takes considerable time By the time the case is decided a new situation may have arisen Lowering or raising rates may have been justified by the economic conditions existing when the case arose By the time it is decided it is quite possible the opposite policy may be more valid

The passenger fares charged by Eastern carriers have offered an inter esting example of the sluggishness of utility rates in the face of changing economic conditions Coach fares had been set at 3 6 cents per mile dur ing the period of the World War During the twenties buses and private cars cut into the railroad passenger service severely but still the railroad rates were maintained During the early days of the depression of 1929

railroads in other sections obtained permission from the Interstate Commerce Commission to experiment with lower rates and most of these carriers decided that the experiment was a success The Eastern carriers however remained obdurate until the I C C in 1936 ordered their coach fares reduced to 2 cents a mile These carriers continued to object to the low rate and were later authorized to raise it to 2 5 cents The latest chapter in the story was the order of the I C C that the Eastern lines return to the 2 cents rate in March 1940 In this case flexibility of prices in the face of extreme competition and of a long continued depression was only secured by the initiative and authority of the I C C and after a long struggle

Public utility rates represent one more type of price fixation in addition to competitive prices privately fixed monopolistic prices quasi monopolistic prices, and the several kinds of prices for governmental services Like other types of monopolistic prices they are inflexible but unlike privately fixed monopoly prices the governmental agencies are supposed to prevent them from being fixed at the point that will bring the greatest net return The theory of regulation is that these utility rates will correspond to what competitive price would have been—will be prices that will cover costs and give a fair return on investment Whether such is the case or not depends on the effectiveness of the regulation

To Administer Prices

It has been shown earlier that in a number of industries prices instead of being determined by competition are set by the administrative decisions of company officials These officials set a price and then adjust production schedules so that the price may be maintained In a somewhat similar fashion through varied types of regulations the United States government has established what may well be called administered prices for the products of certain private industries

Prices administered by means of protective tariffs have a very long history in the United States Firms engaged in certain American industries find that they cannot pay the current rates for labor land and capital and sell their product in competition with goods produced abroad This of course is clear indication according to the functioning of the price mechanism that these firms are inefficient The relatively high prices for labor land and capital have been established by the value productivity of these factors in the efficient industries Such industries have no difficulty in meeting foreign competition—in fact, they frequently are exporting industries In order to be able to pay the necessary rates to secure land, labor and capital the inefficient industries use pressure at Washington to secure protection against foreign competition and through the reduction in the supplies of foreign goods brought about by protective tariffs these inefficient firms are able to sell their domestically produced

goods at a sufficiently high price to enable them to pay high enough rates to attract the factors of production away from the efficient industries Congress by direct subsidies to the inefficient industries could bring about the same result, but the drain on the public purse would be more apparent and the political effects likely less pleasant Tax payers are more likely to prove intransigeant than are the consumers who are exploited by means of the protective tariffs

In addition to the restriction of foreign supplies made possible by the tariffs levied by the government prices of some of these protected goods are further administered by quasi monopolistic policies of the sheltered domestic firms It may not be accurate to say that the tariff is the mother of trusts but it is clearly easier for domestic producers to reach and maintain agreements in respect to price and production policies than if they had to face foreign competition

Tariffs thus restrict competition they tend to reduce the supply of commodities and bring about higher prices they cause a wrong allocation of productive factors This bad allocation is accentuated by the fact that reduction of purchases abroad must eventually lead to reduction in sales abroad, for trade of any kind is only an exchange of goods and services for goods and services Export industries are naturally some of our most efficient industries and a reduction in their sales causes labor, land and capital to be transferred to less productive uses, thereby reducing the real income of these factors The protective tariff therefore warps the operation of the price mechanism just as do other administered prices both by causing an inefficient allocation of the productive factors and by arbitrarily transferring purchasing power from the consumers pockets to the bank accounts of the protected firms If a tariff is protective it brings no revenue to the government and in the words of Mr Dooley the foreigner only pays if he gets by Ellis Island

Our most far reaching experience with industrial prices administered under governmental auspices was conducted under the aegis of the National Industrial Recovery Act of 1933 which was declared unconstitutional in 1935 Under this Act codes of fair competition drawn up and administered in the main by the trade associations with some governmental supervision were supposed to prevent both ruthless competitive practices and unfair monopolistic policies Production and prices were to be administered in the common interests of producers consumers, and laborers It was possibly not to be wholly unexpected that the administration in most industries resulted in restriction of output and price maintenance In some of the codes, as for example those for lumber and timber, petroleum, and copper general restrictions on production and sales for the industry were instituted and quotas allotted the individual firms In other industries output was curtailed by restricting capital investment and hours of operation, and by denying production quotas to new firms

These indirect measures for maintaining prices were supplemented in some codes by the establishment of minimum prices by prohibitions against sales below costs and by the open price provisions Under these open price provisions every seller knew the prices of every other seller and this knowledge tended to bring about greater uniformity of prices Before the Supreme Court declared its unconstitutionality the N I R A was making more general the supersession of competitive prices by administered prices and was making more difficult the attainment of the purposes of the administered prices set up under the Agricultural Adjustment Act

Even during the prosperous years of the 1920s American farmers in general enjoyed no prosperity The prices of such basic crops as cotton wheat corn and of hogs cattle and other farm produce fell markedly while the prices of commodities which farmers bought interest on mortgages and taxes either remained stationary or actually rose in some cases The decline in farm prices was due to both an increase in supply of most agricultural products and a decrease in demand for them The increase in supply was due to the cultivation of increased acreage during the World War and to improved methods of farming made possible by greater use of machinery, better seed and fertilizers and the like Demand declined because of a greatly reduced foreign market and because of a change in the domestic consumption habits

According to the premises of competitive economics the lower prices of farm products should have resulted in decreased supplies until the prices received for the various products equaled their cost of production But it was very evident that this was not occurring The standard of living of most farmers became lower and in many cases they lost or were threatened with the loss of their farms because of inability to pay interest on mortgages or taxes

Why did not falling prices automatically cause a reduction in the supplies of farm products? It was primarily because the factors of production employed in farming are very immobile To a large extent the labor on farms is provided by the farm owner and his family Reduction in his crops would frequently have meant moving from home and seeking a job in some other industry Since farming is both a way of life and an industry even if it had been possible to get other sorts of work the farm owner would have been loath to break the home ties The tenant farmer found it difficult to shift occupations for in the main he was ignorant of other industries curtailment of production by one alone would merely have prevented him from paying the rent required by the landlord For established farmers, mobility merely means growing some other crop but qualities of the soil climatic conditions, specialized equipment and knowledge possessed by farmers placed a severe limitation on this type of mobility Furthermore the prices of practically all farm products were low, and there was little to be gained by a shift in production

The nature of the farming industry with its several million farm units, most of them operated on a small scale, made it next to impossible for the farmers to reach agreements for the curtailment of production Competition did not function to remove excess farmers acreage, and production from the industry, and much of the farm population was on the verge of destitution To meet the situation the federal government began its experiments with administered agricultural prices

Through various devices to be described in detail in a later chapter the federal government has aided or, in some cases practically forced farmers to curtail production, or through its loan program has removed surplus farm produce from the market By these various devices to restrict supply farm prices have been administered at a higher point than they would probably have reached if the free play of supply and demand had been in operation The theory of the administered prices established under the original Agricultural Adjustment Act was that there should be a parity between farm prices and the prices of goods that farmers buy, the relative prices between these two types of goods during 1909 1914 being considered the proper parity In other words the attempt was made to set a price say for a pound of cotton that would cause cotton to exchange for other commodities in the same proportion as in 1909 1914 Under the revised A A A the parity payments by the government are for the purpose of equalizing the farmer's real income with his income during 1909 1914

The most commonly expressed criticism of the crop restriction program that it is bringing about an artificial scarcity is rather beside the point From a strictly economic view no good should be produced whose price will not cover cost of production and certainly when a large proportion of the producers in an industry are not receiving a price that will cover costs and it has been shown as in the case of the farmers that competitive forces will not bring prices and costs in line with each other, to avoid a collapse in the industry administered prices under governmental auspices are quite defensible Interestingly enough, some of the chief objections to administered farm produce scarcity have come from members of industries who have been practising the creation of scarcity for years

A much more valid criticism can be aimed at the parity policy of the administered agricultural prices No sanctity is attached to the 1909 1914 price or income relationships and even if such relationships were completely accurate in that period, there is no reason to believe that this accuracy still exists Changes in the technique of production and in the demand relationships make the parity of some previous period of doubtful value as a present criterion of price or income relationships The administered prices for farm products would serve their purposes far better if their basis was present cost—in other words, if production was restricted for the purpose of maintaining prices that would equal cost of production to representative farmers

As has been suggested earlier the administration of farm prices begun by the federal government in 1933 and the prices administered under the N I R A with governmental benediction were in part contradictory The attempt to give farm produce a purchasing power equal to that of 1909 1914 was made more difficult by the price raising features of N I R A Furthermore, a fairly large percentage of the basic farm crops had previously been sold in foreign markets and the higher prices brought about by A A A has further restricted foreign sales

It has been shown earlier that the premises on which the case for competitive price determination rests are not at all accurate in the determination of wages where individual bargaining between employer and employee exists for the individual employee does not have equal bargaining power with his employer For the purpose of equalizing this bargaining power many groups of laborers have formed unions which carry on collective bargaining with the employers But up to the present it has been impossible for many unskilled laborers to form unions and several states and the federal government have enacted legislation to put a floor under the wages of the most poorly paid These state minimum wage laws and the federal wages and hours legislation are thus applying the principle of administered prices to the determination of wages If the legally established wages coincide with the wage rates that would have been set if there had been equal bargaining power between employers and employees there will be no effect on the demand for labor If on the other hand the minimum payments are set above the point representing the value product of a particular type of laborers the point presumably at which the wage rates would have been established if perfect competition had been in operation employers will hire fewer workers As in the case of any other type of administered price, price may be set higher than if the forces of competition had been fully in operation but at this higher price there will be smaller demand

Summary

In the United States the price mechanism determines in the main what goods and services will be produced and in what quantities it determines the allocation of the productive factors and the recompense to them and it rations goods and services among consumers The various prices constituting the price mechanism are not determined however in one uniform manner Some are determined in an almost purely competitive fashion and then by almost imperceptible gradations some monopolistic element enters in until the point is reached where in many industries prices are administered under conditions of monopolistic competition until finally in a few cases private enterprises exercise complete monopolistic control over prices Furthermore, there has been an increasing tendency for government to play a part in price determination These governmental

activities range from attempts to enforce competitive prices through the regulation of the prices of private monopolies and through governmental legislation to administer the prices of certain commodities and services to many cases where the governmental units establish monopolistic prices for their own goods and services

The price system composed of all these heterogeneous types of prices is thus a complex mechanism But whatever the type of price it is performing essentially the same function—apportioning scarce economic goods and services among their various uses or users And in no case is the price divorced from the relationship between supply and demand Competitive prices are the result of the interactions of supply and demand Administered prices whether administered by private industry labor unions government or any other group cannot be fixed at a point higher than competitive price without restricting demand and therefore curtailing sales The increased use of this type of price has not reduced the importance of the price mechanism in our economic system nor has it nullified the influences of the forces of supply and demand It has simply for good or ill expanded the area in which personal decisions in regard to price determination and size of output play a somewhat more important part than the automatic working of the demand and supply schedules of many small producers and consumers

PART IV

Government Control of Business

CHAPTER 10

THE BUSINESS INTEREST IN GOVERNMENT

Get off this estate
What for?
Because it s mine
Where did you get it? '
From my father
Where did he get it?
From his father
And where did he get it?
He fought for it
Well I ll fight you for it ' [1]

The offer of the trespasser is obviously bad The time for acquisition of property by force is past Because government and law protect the ownership and use of property it is no longer necessary for an owner to enter into physical combat to save his property from one who desires it and would fight to acquire it An owner is accordingly dependent for all that he possesses upon government

Business Dependence Upon Government (a) For Property

To say that government should stay out of business is equivalent to saying that our modern business system should be abolished Business is based upon property The business system of today involves no more than organizations using property in those ways to which we have given the name business Thus governmental protection of ownership and use of property are essential to the very existence of modern business Imagine what would become of our stocks bonds, interests equities wages land buildings machinery profits and money if it were not for government with its legislatures, President and Governors police courts, administrative officials, army and navy!

Government not only creates property and protects the owner s possession against physical seizure by a non owner who may be stronger in brute force, but it also guarantees a very broad discretion in the use of that property Under governmental protection the title holder may let his property stand idle if he wishes If it is land he may refuse to produce crops on it If it is building and machines he need not produce the goods which they are capable of producing Or if he does produce, he may

[1] Carl Sandburg *The People Yes* (Harcourt Brace and Company 1936) p 75

within limits decide how much or how little or of what quality Being the owner of the goods he produces he may ordinarily decide for what price he will sell those goods and if economic forces prevent him from getting the price he desires he may refuse to sell Should he refuse to sell he may store his goods in a place of safe keeping or he may destroy them These things the government protects him in doing even though consumers want and need his goods even though people are starving for the lack of his food or are freezing for lack of his clothing or his fuel or his building materials or his houses The system of prices therefore depends upon the existence of government and its protection of property

If the property be capital the owner may sell its services to whom he wishes Should the interest rate (the price) be lower than he desires he may let it stand idle Also he has a choice whether to spend his money or to hoard it and if he does the former he can choose within limits where and for what to spend it He can buy better clothing or poorer clothing food or clothing, a car or a trip to Europe, a coming out party for his daughter or more machinery or land with which to produce more property which he would also own And whatever his choice another person who objects to it or who wants (or needs) his money cannot take it away from him because the government through law, police and courts protects the owner from theft Consequently, the government enables business men and consumers in the mass to direct whether and what industry shall produce and in what amounts

(b) For Currency

Business is also dependent upon government for currency It is perfectly obvious that we could not have our great and vast industrial and business processes with a system of simple barter and exchange Government money supplies a necessary medium of exchange To be of the greatest possible use to business that medium must be uniform in value and therefore firmly regulated by a strong central government This need in fact was well recognized in 1787 and was one of the principal reasons why the business men of the period were so strongly in support of the Constitution of the United States which was drawn up at that time Previously the Continental Congress and the thirteen states had been issuing different moneys all with different exchange values Also, the various state moneys fluctuated greatly in purchasing power The result was that business was hindered by this great uncertainty This defect was corrected by constitutional provisions giving the new government of the United States power to coin and control the value of money Consequently today all our government money originates with the United States government which has complete control over it and it is the same money from Maine to California Business approval of nay demand for this change shows that it recognized and asserted its dependence upon government

(c) For Contracts

Contracts permeate the entire business world It is through contracts that modern business organizes and plans its activities Business men make contracts to buy and sell to pay to fix the responsibilities duties and obligations involved in ownership management financing and marketing and to arrange for the employment of workers Contracts are frequently prerequisites of production and thus of business

In another respect therefore modern business is dependent upon government for its existence because contracts are created and enforced by government Only those agreements which the courts approve are contracts and only those are enforceable

The system of business contracts is created by government protection of property Each of the parties to a contract has something which the other wants or needs Each has something which he desires to or which he must surrender in order to acquire that which the other has Where this thing is property the government s protection means that it can be acquired only for a consideration which the owner is willing to accept For example the producer of automobiles needs tires and the tire manufacturer has tires The former cannot simply take the tires because the government has established by law ownership in the latter and through its police and courts protects that ownership Likewise the automobile company has money which the rubber company wants but cannot get by simple appropriation for the same reason Therefore each *must* get what he wants through an agreement to exchange This is a contract The same relationship exists between the automobile producer and his retail agents who repeat it with the purchaser of the automobile

A business contract is of little value unless each party knows that the other will keep his promise If the tire company sends the tires how does it know that the automobile company will pay for them? Or if the automobile producer sends the money how does he know that he will receive the tires? Is it necessary for both to meet at some point and make the exchange simultaneously? This of course everyone knows does not happen and if it were necessary the mere physical impossibility of it would be an insurmountable obstacle which would have prevented the present day development of American business As a general rule each party would know that the other would perform his part of the contract because of his honesty, moral obligation or economic self interest The fact is nevertheless that the ultimate security for both parties is the knowledge that the government stands ready with its agencies and its power to enforce the delivery Government enforcement runs through the whole series of relationships involved in this example including that of the payment for the car by an instalment buyer in accord with the terms of the instalment contract This contract is just as important to the automobile industry

and to all the businesses associated with it as is any other contract in the entire automobile business

Because of this system of contracts business is enabled to plan or the future If the automobile business could not depend upon governmental enforcement of contracts it could not know with certainty what supplies of raw materials it could depend upon and thus what it could produce in the future Likewise, its market would be very drastically limited because sales could be only for cash when the seller did not know that the government stood behind him in collecting from an instalment buyer The importance of contracts therefore in modern industry has established business interest in and dependence upon government

(d) For Organization

Government also plays a vital part in the organization of business The partnership is created by a contract between the partners and the terms of the contract determine the nature of the partnership Inasmuch as the contract is created and enforced by government it is thus essential to the existence of this form of business organization On the other hand while many of the details of the organization of a particular corporation are defined by contracts, the corporation itself is created by specific governmental action Without government business men today could not organize a modern corporation with all of the characteristics which make it so vital to the modern business world as we know it Government establishes a corporation by granting Articles of Incorporation for which anyone who desires to set up a corporation must petition Thus there is first the request by business men that the government give them a corporation and they cannot have it until the government acts

The corporation is a dominant feature of modern industry Business men want it and would indeed fight against the government getting out of business if that meant the end of the corporation It is well adapted to a business world which depends for its raw materials upon widely separated sources in the nation and in the world which sells its goods and services on national and international markets and which requires enormous capital resources necessarily acquired in small amounts from many people The business men also like it because it provides a limited liability and many protections from risks and because it facilitates the control and use of other people's money—characteristics not possessed by the simpler forms of organization such as the proprietorship and the partnership If, therefore, modern industry maintains its present organization and size with the help and use of the corporation the conclusion is inevitable that our business system would not be what it is today without government

These Governmental Functions Coerce as Well as Help Busines

When business men say that the government should get out of business when they take a stand in favor of laissez faire and rugged individualism they do not mean that the government should cease protecting their property or stop enforcing contracts or abolish money, or refuse to create any corporations On the contrary business men want and insist that the government should perform such functions

It is vitally important to any understanding of the relations of business and government that this attitude be analyzed Why should business men approve of the above activities of the government while at the same time saying that government should let business alone? The answer is probably two fold these functions have been performed by government for such a long time that people have become accustomed to them and no longer question their propriety and business men think of them as *helping* rather than as *restricting* or *regulating* their freedom

Accordingly the soundness of this way of thinking is brought into question Is it true that these governmental activities protect but do not restrict the freedom of business men?

The truth of the matter is that what helps some businesses also restricts other businesses This will immediately appear evident as soon as one grasps the idea that there is no such thing as a unified business interest in which all businesses have the same stake in governmental action In fact business is divided into a great number of conflicting interests Therefore governmental promotion of the interests of one business becomes immediately a coercion of another business And this coercion exists in the governmental actions described above and approved by those who say they object to governmental coercion of business The result is that such individualists are supporting governmental interference in business in the form of governmental help *and regulation* of business

The immediate cause of the coercion is the economic power over other people which lies in the ownership and use of property For this reason at first glance the coercion appears not to be governmental On further analysis however the owner and user of property possesses his economic power over others only because the government protects him and makes his economic power possible His power to restrict and coerce others is dependent upon government The result is that the coercion becomes a kind of governmental regulation

Examples of Coercion (a) Owner vs *Non Owner*

This help which implies coercion will become more apparent with an analysis of a few examples Governmental protection of property owners is coercive on those who do not have property or on those who want

more property than they have Because of this protection they cannot simply acquire it by force In the simplest situation this may apply to food or clothing All persons need them in our society and they may be property owned by others Governmental protection of this ownership means that one who needs food or clothing must either produce them or use property he possesses (money) to acquire them But in both cases he *must* have property He cannot produce his potatoes unless he has land and he cannot because of governmental coercion on him go upon the land of another and raise his potatoes there To use that land he must pay the price (rent) charged by the owner for that use all of which means that he must have property in order to produce more property Likewise the protection of the restaurant s property means that the diner is coerced to produce property so that he can eat

Many persons are therefore forced to work for wages on the property owned or controlled by others The protection of that property coerces the non owner If instead of producing property (wages) for himself by laboring on the property of another a person chooses to enter a business he is in the same position Not having property he cannot produce with out it because it takes property to produce property He cannot steal it because the government coerces him Therefore he must get the use of the property owned or controlled by others and in so doing he is coerced by governmental protection in meeting the conditions which they set up He must meet the terms of the owner or controller of money of land, of machinery and of raw materials

(b) Management vs *Investor*

The same regulatory effect of governmental protection of property exists as between property owners One such conflict is that between in vestors and management Suppose a man owns $100 000 the possession and use of which are protected by the government If instead of spending it he decides to invest it a mutually coercive relationship is created He is limited by the opportunities for investment and by the terms which the owners or controllers of physical property can legally make because of governmental protection The latter in turn are limited by the terms which the capitalist is free to refuse or to accept because of governmental protection of his property The dominance of its business world by the corporation has made corporate securities the biggest field of investment and has reduced to a large extent the investor s control over his money Due to the growth of large corporations and the corporate devices of minority control many investors are practically helpless They are forced to accept the terms the corporation will grant them or withdraw their investments They have little control over what they will get or over the use to which their money will be put Due to this lack of control they are forced by the corporation, under the government s aegis, to take risks, of

which they are usually ignorant, even to the extent of losing their capital while they sit helplessly by

(c) Shipper vs *Carrier*

Among property owners in the business world there are other conflicts of interest resulting in restrictive as well as protective government action These conflicts exist where different businesses are performing different functions all of which are necessary in our modern business economy One such conflict would be in the relation between shippers and transportation interests It is obvious that production is for a market that the market is frequently far from the point of production, and that therefore it is necessary for a producer to use the transportation business But governmental protection of the property of the latter means that the former is regulated in the use of the facilities of the latter The producer of coal of automobiles of rubber of steel for example *must* pay for transportation to the market and *must* be dependent upon the services which transportation interests offer The regulatory effect of this governmental protection of ownership and use of the property of the railroads is shown by their control of shippers prior to the time when the shippers demanded and got governmental protection of themselves by regulation of the railroads through the Interstate Commerce Commission The railroads by discriminatory rates and by withdrawal of services were able to drive many businesses to the wall and this would not have been possible without governmental protection This means and must mean that governmental protection of railroad property amounted to governmental regulation of the shippers

(d) Business Consumer vs *Business Producer*

Many businesses are the consumers of the products of other businesses Thus coal, oil electricity glass rubber, machinery and many other goods are the raw materials of some industries Production of these goods is for this market the producers wanting the dollars of the consuming businesses which want the goods of the producing businesses The result is that the government s protection of the materials which some businesses produce for other businesses and of the money of the consuming businesses establishes a mutually coercive relationship The two industries are required to get what they want from each other by meeting the conditions which governmental protection of the property of each enables it to require the other to meet

(e) Bigness vs *Littleness*

Another business conflict of very great importance results from differences in size This is the old big business little business conflict of which we are hearing so much today and which has been so important in

American history, particularly since the latter part of the last century It seems evident that there can be today no large mass industries or enormous corporations and trusts without government In the first place property such as land buildings machinery etc is necessary As already shown ownership and use of this property is dependent upon govern mental action In the second place Bigness is dependent upon the cor porate form of organization Through the corporation capital is accumu lated by providing investment opportunities for owners of money who are protected by limited liability The corporate form also offers an incentive to management in providing control of enormous wealth which is not owned which control permits management to direct the wealth to the economic process involved And this corporate form in turn comes from government The coercive feature comes from the economic force which big business possesses because of its wealth and corporate power This economic power enables it to dictate to small business all the way from the specification of conditions upon which it will permit the func tioning of little business to the absorption or destruction of small com petitive businesses The inevitable conclusion therefore is that if Bigness can and does coerce Littleness and if Bigness is dependent upon govern ment the performance of the stated functions of government amounts to governmental regulation of Littleness

And this has been recognized by small business American history since the latter part of the last century echoes and reechoes with the clamor of business men for governmental protection against the coercive power of Bigness in other words for government regulation of Bigness One out standing example of this is the fight to get and to enforce the anti trust laws

(f) Competitors

There is also a conflict of interest between competitors in the same business governmental protection of one amounting to regulation of the other Both depend upon government for existence and by keeping both in existence the government is maintaining conflicting business each of which restricts the freedom of the other Many examples could be given For instance in the transportation business, the existence of bus and truck companies dependent upon government, takes traffic away from the railroads and vice versa To these could be added steamship com panies and air transportation The fuel business would be another Fuel oil companies have been making great inroads into the coal business and today electric power is becoming a still greater threat to both These businesses recognize this coercive effect of the performance of the very governmental functions of which they approve even though objecting to government interference in business This is shown by the demands which they have made upon government Trucking interests have approved of

government regulation of railroads as a means of reducing the coercion upon themselves while railway companies have clamored for governmental regulation of bus and truck lines for the same reason Many business men have used the Federal Trade Commission to control the practices of competitors which were restrictive and therefore thought by the objecting business to be unfair and contrary to public interest

Business Pressure to Get the Government into Business

The interest of business men in governmental action is not limited to the performance of the functions already described and shown to be essential to the modern industrial system in the United States These functions are taken for granted today and there is no pressing need to assert support for them

Business men are interested in many other governmental activities and accordingly are organized into various groups and associations to express their desires Far from consistently struggling to keep governmental activities limited to the ones previously described in this chapter or to push the government entirely out of their affairs business men have been and are working to get the government involved in the business world in a greater variety of ways

Government is of more importance to industry than as a protector of its existence The various organs and officials can do or refrain from doing many other things which business men desire them to do Business men are just like other people in our society They have ideas on the desirability and necessity of various governmental activities They are at times motivated by economic self interest and at other times by moral ideological and idealistic influences Like every one else they try to get the government on their side to induce it to do the things which they would like to see done and to try to prevent conduct which they dislike or fear

Government has a great deal of power Through its control of the relations among individuals and among social institutions it can often maintain the status quo or influence the kind and direction of social change The struggle of any group of business men is therefore to get the government on its side of social economic and political questions and to induce it not to throw its power and influence upon the side of other business groups or of such groups as workers or consumers

Whatever the government does is decided by its officials who possess a great deal of discretion Business men bring pressure on these officials in attempts to influence their decisions Whether these efforts are or will be successful in any particular instance cannot be said with certainty The relation between cause and effect is too vague and complex to provide any conclusive evidence All that can be said is that pressure is exerted that sometimes the desired governmental action does follow and

sometimes it does not The demands and desires of various groups of business men on governmental activity are clear and known It also seems clear that business pressure groups do have considerable influence upon these activities

The two large national organizations of business best known to the public are probably the National Association of Manufacturers and the United States Chamber of Commerce There is also a network of organizations along the lines of the nature of the business or of the functions performed in our economic system For example there are the Iron and Steel Institute the American Bankers Association the Wholesale Grocers Association Some businesses are divided into organizations in accordance with geographical divisions such as the owners and operators of coal mines which have associations in the East South and West

These organizations have many ways of exerting their pressure on the government One is the lobby agents maintained in governmental capitals by business organizations The lobbyists keep their employers informed of events in Washington (the same is true in state and local governments) express their position on governmental policies in which they are interested and try to influence governmental officials Another method is the issuance of propaganda through advertising newspapers radio and mails in the attempt to build up a favorable public sentiment to defeat or to elect candidates for office to secure or to block proposed legislation, and to influence law enforcement These organizations also act through political parties particularly the Republican and Democratic parties This is done by influencing the party s activities by promises of support or threats of opposition and by contributions to campaign expenses

Conflicts of interest and ideas among business groups often causes them to work at cross purposes Often one organization wants a particular governmental action for which it exerts pressure while another objects and tries to prevent that same activity One very good example of this is shown by the report of a lobbyist for a trade association who in reporting the Washington scene for the information of the members of the association, lamented bitterly how lobbyists for other trade associations were working for unemployment relief spending to which his association was opposed A very interesting example of a conflict of pressure within a large business pressure group occurred at the 1939 convention of the United States Chamber of Commerce in Washington While the national organization was taking a stand against government spending and in favor of balancing the budget, some of the delegates from local chambers, constituent members of the national organization, were in their spare time from convention meetings working on governmental officers to get larger sums for spending in their own communities

The Kind of Governmental Action Business Wants

While it is true therefore that business men do not want the government to get out of business and that they do want the government to do more things to and for business it is not true that all of them approve of *all* the relationships of government and business Their organizations exert pressure *against some* governmental activities as well as *for others* It is only apropos of action which is thought to be injurious that the individual business man or organization wants the government to let business alone In other words the business man wants that governmental interference in business which he likes and does not want that which he does not like

It cannot always be said just why business men like or dislike particular governmental activities There is too great a multiplicity of motives to enable one to describe all the reasons for any one s conduct On the other hand we do frequently have evidence that business groups do demand and use efforts to try to secure specific governmental policies and activities

The thoughts and actions of business men like other people are often determined by what they think is to their own economic interest They have ideas of what government can do to help them in their businesses and what it can do to hurt them They may not always be right in their ideas and there is plenty of evidence that they often disagree on what is help and injury Furthermore they can never be sure of the consequences which might follow at some future time the granting by the government of the things they want Particular acts thought to be helpful might turn out ultimately to be in some unsuspected way injurious or restrictive One excellent example would be the fight of the merchant marine for governmental loans and subsidies which is described more fully in a subsequent chapter Along with financial assistance it received a very thorough regulation and in some instances loss of financial control of particular companies Another example would be the fight of some employers during the World War against governmental attempts to settle labor disputes They found themselves deprived of control of their own companies when the government took them over and operated them for the duration of the war a result they could have avoided had they more wisely judged their own economic welfare The fact is however that whether a business man judges his economic interests rightly or not he does often judge them and acts accordingly That is enough to constitute economic motivation for supporting or opposing governmental action

It is not to be said however that business men any more than other people always think and act in terms of their ideas of economic self interest They often make decisions that are economically injurious to themselves In other words, they are influenced by the ideals symbols

and the scale of moral values which are possessed by the society in which they live They are often motivated by the desire to advance the public welfare by the force of such slogans as red tape political corruption, inefficiency of the government sound public finance and many others Humanitarian and eleemosynary objectives may cause them to support or oppose particular governmental activities regardless of their effects upon their own economic welfare Accordingly opposition may be expressed against governmental appropriations for business subsidies on the ground of the necessity for balancing the budget or approval may be given to relief spending because of the dependence of many people upon relief for subsistence Government ownership and operation of some business may be opposed because of a belief that government is incapable of operating a business Another example might be support for elaborate expenditures for military armament and preparedness for war because of patriotic motives and symbols and a belief that such activities are necessary This position might be taken even though it means governmental limitation on profits regulation of production and protection of employees and higher taxes

When all is said however, probably the most common and the most dominant motive for the attitude of organized business interests toward governmental policies is the economic one To some people this means that one acts in accord with his own economic self interest But that is erroneous Economic motivation means that one thinks that he is furthering either his own or the nation s economic welfare whether he is actually and realistically doing so or not

Because of the conflict in the economic interests of American business men and the great variety of motives which determine their attitudes toward the relation of the government to business it is not surprising that all business men do not agree in supporting and opposing particular governmental activities In fact it is to be expected that in most instances some business men will desire and some object to particular relationships And such is the case Most if not all governmental policies which affect business are supported by some business men and opposed by others One must therefore view with considerable skepticism such generalizations so popular today on the subject of government and business as government should let business alone government should help but not regulate business government should not stifle individual initiative and incentive and that business men should be permitted to survive or perish upon their own merits As generalizations they appear desirable to many people and have a great deal of influence in affecting people s attitudes towards government and business They do not have the same weight however when particular governmental activities are called in question These slogans are not used against governmental protection of property

enforcement of contracts coinage of money and creation of corporations Business men do not want to stand on their own feet when it comes to these functions Likewise those business men who want for any of the great variety of reasons pointed out above other governmental activities do not use these slogans They are invoked only against those things which again for a variety of reasons are not wanted The result is that these business slogans are often used by some business men against a law to which they object but not used by other business men who want that same law

Individualism

Individualism whether it be the rugged or the plain variety therefore means different things to different persons and under different circum stances Business men do not mean by it that the government should not help them Rarely if ever is a business man to be seen refusing or object ing to such governmental action If it is construed to mean that the government should not coerce or regulate business it is not embraced by all business men at all times because business support is to be found behind most government regulations of business as will be shown in a later chapter Also as already shown business men almost unanimously support governmental protection of property enforcement of contracts and creation of corporations even though these activities do have a coercive and regulatory effect on business If it is taken to mean that government should restrict itself to these activities it is neither observed nor desired by business men as shown by their constant and persistent efforts to increase the number of governmental activities

Individualism has come to mean to each person that which he wants and which he believes to be desirable For that reason it is synonymous with good Therefore when a particular governmental activity is approved as in accord with or disapproved as a violation of individualism the term becomes an effective instrument to influence the opinions or actions of other people On the other hand to say that the government is violating individualism by a particular course of conduct will not change the attitude of those who want that conduct Wanting it they will not believe that it is bad and thus a violation of individualism As a matter of brutal fact the symbol of individualism is invoked only against that which one for any number of reasons does not want

Business men are to be seen therefore pressing the government to do more and more things in the business world without compromising their own ideas of individualism while other business men object to these same things and see in them violations of laissez faire The latter see in these governmental activities to which they object fascism socialism ‘communism or dictatorship Having merely become symbols of good

and bad without real substance the only difference between these words as actually used today is the approval or disapproval which it is desired to express

Business then has served to increase the activity of government in the business system and this is true whether that activity is one which helps or regulates business As our industrial society grows more complex we have a greater number of business interests which ask the government to do more and more things for them This spells business support for an increase in the quantity of governmental interventions in business With this increase the number of interests which various businesses acquire in government also increases

The fact that there is also business objection to nearly every additional activity of government means that as time passes the amount of controversy over the relation of government and business increases Thus speculation over separation of governmental functions into primary and secondary or into proper and improper groups is valueless Any action which one wants the government to undertake is to his mind a proper function for the government and any activity to which he is opposed is improper

CHAPTER 11

GOVERNMENT HELPS BUSINESS

The record of the relations of government and business shows that business men frequently want the government to help them by protecting them from other interests in our society such as workers or consumers and from other business men and that they do not want to face loss of profits or failure and bankruptcy where they are not able to survive in the hurly burly of competition In fact one of the accepted slogans of the business men is that government *should* help business This is to be seen in the motto of the United States Chamber of Commerce What Helps Business Helps You

Government Protection from Competition (a) By Tariffs

After the establishment of American Independence the business men of the states received protection from the competition of each other by state tariffs and other trade barriers As a result American business was essentially localized within state boundaries and the Atlantic seaboard was covered with a net work of trade restrictions—state against state

The coercive and restrictive effects of such trade protections of local business was one of the leading reasons for the formation and adoption of the United States Constitution with its provisions prohibiting state interference with state exports and imports and granting the power to regulate interstate commerce to the new national government Business men, however, did not want to meet the competition within the United States of the much more powerful foreign industries They wanted the government to protect them from getting hurt where they were unable to protect themselves without its help Consequently in the first administration of Washington Alexander Hamilton spokesman of American business and property, drew up a tariff program to provide that protection

That one of the objectives of the tariff is to provide government protection of business is shown by Hamilton s Report on the Subject of Manufactures" and by the fact that the tariff has ever since been called a protective tariff in the United States What it protects is therefore significant A protected industry is not compelled to face the problem of cutting production costs to meet the competition of foreign producers The tariff increases the price of the foreign product to the consumer and this higher price means that the American producer need not compete

with the lower production costs of the foreign producer The higher price guarantees to the protected industries an American market for their products by decreasing the market demand for the competitive foreign products Purchasing power is limited and the income of many consumers is small They must buy the cheaper goods For some American industries this means a guarantee of continued existence because foreign industries can produce some products so much more cheaply than can American producers that the latter would be driven off the market if they had to meet the competition The tariff eliminates the advantages which these foreign industries have in lower costs of production and upon this protection the existence of such American businesses depends Also the tariff guarantees to some American industries higher profits than they could make if there were no tariff This protection occurs in those businesses which could meet the production costs of foreign competition under a system of free trade and which have no considerable domestic surpluses In so far however as the tariff raises the market price of the foreign goods the American competitor can raise the price of his products Thus by charging the consumer more than his costs of production justify the protected American business man can make more money because of tariff protection than he could make if he had to charge lower prices to meet the prices of the foreign competitor

Accordingly some businesses such as cheap textiles or sugar are dependent upon the tariff either for existence or for the maintenance of production levels and profits If they were unprotected by the tariff from Japanese textile or Cuban sugar industries they would be hard put to maintain present levels of production On the other hand the steel industry, while no longer needing tariff protection for its continued existence as an infant industry is enabled because of that protection to maintain a price level and a profit margin completely out of proportion to its capacity to meet the unfettered competition of foreign steel interests The protected businesses are well aware of this protection They have shown no reluctance to put pressure on the government to keep what protection they have already achieved and to acquire as much more as their political power can get for them Organized steel has maintained a powerful tariff lobby in Washington and has been quite successful in getting the government into business to its own advantage The concentration of that industry in Pennsylvania helps to explain the traditional high tariff position of governmental officers coming from that state American sugar refiners have succeeded in warding off many attempts to decrease their tariff protection and have in fact succeeded in getting more of it During the early years of the Harding administration and again later in the Coolidge administration reports of the Federal Tariff Commission disclosing the disproportionate protection which the sugar businesses had been getting from the tariff, pointing out the correspondingly

heavy burden which this protection had been placing upon the American consumer of sugar and recommending a decrease in that protection were vigorously fought and successfully suppressed

These pressures are clearly portrayed in the process of Congressional tariff making Many business and other lobbies interested in tariff protection combine together in a form of log rolling to support each other s tariff schedules This unites behind each group the political influence of many such interests and our history demonstrates the great power of this combination through its recorded successes It makes little difference whether the party in power is the Democratic or Republican party Many attempts of the former to lower tariff schedules have been totally or partly unsuccessful The trend in American tariff making has been upward The anti tariff pressure interests have frequently blamed the party or the Congressmen for tariff results but this blame is completely unrealistic It does demonstrate a way of thinking about the American government however It shows that people blame the government for what it does rather than realistically looking at government officers as agents of the interests behind them Officers thereby are forced to perform the scapegoat function that is the assumption of responsibility for giving politically powerful interests what they want in perfect accord with democratic principles

Reaction against tariff making motivated by the desire for self protection resulted in the adoption by the Wilson administration of a policy of ' scientific tariff making A Federal Tariff Commission was created to study tariff rates and to modify those rates in accordance with a stated formula namely the rate should be just high enough to bridge the spread between costs of production and marketing of the American and the foreign competitors on the American market The high tariff lobby did not vigorously object to this proposal In fact one such lobbyist told a congressional committee that the tariff interests did not object because they knew that the new method meant only that their activities would be transferred from Congress to the administrative commission

And that is exactly what happened The first Tariff Commission was predominantly low tariff in sentiment but its work was made ineffective by opposition The pressures first succeeded in concentrating the actual power to change tariff schedules in the President leaving with the Commission only the authority to make recommendations Harding and Coolidge frequently refused to make low tariff recommendations effective They simply ignored the Commission's recommendations on the sugar tariff In other cases the reports of the Commission were declared unsatisfactory and sent back to it for further investigation This usually delayed any action with the high protection continuing unabated in the meanwhile Such blockages, of course are discouraging to conscientious workers and seem to have cooled the ardor of many tariff reformers The

next weakening took the form of decreasing the Commission s control over its own investigations through the practice of Presidential or Con gressional instructions to the Commission as to what schedules it should investigate Therefore when it appeared to a protected group that its tariff was being investigated or was about to be investigated the group had merely to get Congress or the President to divert the investigation by instructions to continue an old one or to conduct another one Further control over the Tariff Commission was gained by the high tariff lobby upon the expiration of office of various Wilson appointees Commissioners with low tariff sympathies were simply replaced by ones believing in higher protection The result was that by the end of Coolidge s period in the Presidency the Tariff Commission was virtually in the vest pockets of the advocates of high protective tariffs They didn t mean to let the government get out of business or to permit a decrease in the protection which the government had already established

The Harding Coolidge and Hoover administrations saw a negligible decrease in some tariff schedules and a considerable increase in others That is to say the protected interests were not content with the amount of protection which they had been receiving They wanted still higher tariffs and accordingly they succeeded in breaking the back of the old Tariff Commission by getting congressional enactment in the Hoover administration in 1930 of the Smoot Hawley Tariff—the highest tariff in American history Thus the whole attempt at getting tariff making on any other grounds than those of pure maximum protection of business by government was denied When these groups wanted a higher tariff they got Congress to give them one and this despite the policy of adminis trative tariff making During the New Deal many attacks against the reciprocal trade agreements policy of the Roosevelt administration have come from the businesses whose protection is being decreased

The system of trade quotas is another form of governmental protection of the market provided by tariffs This is done by specifying a certain quantity of goods which can be imported with the result that the domes tic producer is guaranteed the rest of the market This is the case with sugar under our present trade regulations For example, Cuban sugar interests are told that they cannot send into the United States sugar beyond a fixed amount A change in this quota in the last reciprocal trade agreement with Cuba aroused the antagonism of the American sugar interests because it gave them less governmental protection than they desired

(b) *By Other Market Restrictions*

There are many kinds of trade restrictions within the United States which have the effect of protecting particular markets for particular busines es and which are therefore supported by these businesses Under

the guise of sanitary and inspection laws many of the states have been trying to keep out or to put at a fatal disadvantage out of state products in the state markets In Minnesota v Barber the United States Supreme Court declared unconstitutional one such attempt In that case the state law required a form of inspection for meat brought into the state from other states which if followed would have effectively kept out such meats Other states have been more successful Under the guise of inspection to prevent the spread of plant diseases California effectively embargoes the importation of certain agricultural products In many large American cities the building codes ostensibly to guarantee safe construction and to prevent depreciation of property rights serve to place such disabilities upon out of town contractors and supply companies as to amount to a protection of a monopoly for such businesses within the city

In the transportation field the requirement of state law that business secure a franchise and a certificate of convenience and necessity before it can operate and sell its services to the public very frequently serves to protect the transportation businesses already established Having received franchises they work very diligently to see that no new business can compete with them A recent example is the petition to the New York Supreme Court by the New York New Haven and Hartford Railroad for an injunction which was granted against the taxicab business in Westchester County of New York The injunction forbade the taxi drivers from carrying commuters from towns in Westchester to a stop on the New York City subway on the ground that they had failed to get a franchise This decision effectively gave the railroad a monopoly of such commuting business and it was diligent in seeing that the government through its courts protected its market from competition There are many other cases in the courts where established businesses have used the franchises given to them by the government to prevent competition and to protect their own interests Radio broadcasting licenses may be given as examples Those companies to whom licenses with favorable wave lengths and hours have been issued do not permit rugged individualism to prevent them from accepting the government s protection of their license monopolies against competitors who might also want those wave lengths and hours

Government Aid by Indirect Subsidy

These governmental protections of business interests frequently amount to the grant of subsidies to such businesses The factor of competition is absent or partly absent with the result that the businesses can charge higher prices which the consumer must pay (or do without the service or product) and therefore the governmental protection means that money is taken from the consumer and given to the protected businesses Because of the tariff for example the American people must pay more for sugar

meat steel, and many other things If the tariff is high enough to make the market price of foreign produced sugar high then American producers of sugar can charge similar or much higher, prices than they could charge if they were forced to compete Also market protections frequently mean that the consumer cannot get the same goods such as meat or sugar, or that he cannot buy the same services at the lower costs offered by the competitors who are kept off the market Accordingly he must meet the terms of those who control the market under this governmental protection

Market protections are not the only indirect subsidies which the government gives to businesses There are many others and all of them are approved and desired by the recipients Whenever the government provides a service to a business at no direct charge for the service or at a charge less than cost that business is getting value without payment in full It is expensive for the government to provide these services and the costs being met by general taxation means that the government takes money from others and gives it to business

One indispensable service which business receives from government is protection of property without which as already explained modern business could not exist This protection is provided by the police courts jails penitentiaries, and the armed forces These establishments are very elaborate and today constitute a major item in governmental expenditures The police protect from all varieties of theft or other practices which our criminal laws prohibit Incarceration in penitentiaries protects business property from the prisoners found guilty of having committed offenses against that property during the period of their incarceration The costly attempts of police and penal administrations to reform budding violators or hardened offenders against business property are designed to make that property safe from their depredations in the future after release from prison The government maintains a great number of courts with their elaborate organizations and great expense and thereby provides a service to business in the enforcement of its contracts and in the punishment of those who violate its property

If a foreign government within whose jurisdiction American property is situated is too weak to provide protection the United States may intervene with its armed forces Accordingly we find American military and naval forces protecting American owned oil and furs and American financial interests in the Far East and American tobacco in the Near East If the property can be but is not protected by the government of the country in which it exists or if a government itself violates American business interests the United States gives protection through its Department of State and its diplomatic service Recent diplomatic protests to Japan Germany Russia, and Mexico are examples Furthermore should diplomatic negotiations fail to secure the protection the United States has frequently been ready to use coercion or other pressure to force the

foreign government to give the protection Accordingly we have trade restrictions against Germany and Italy and financial discrimination against Russia

And businesses demand these protect ons American business interests in China are constantly demanding that the United States government furnish protection against Japanese bombardments and against Japanese regulation of trade in China and Manchukuo to the discrimination and disadvantage of American trade Some businesses became extremely vitriolic against the failure of the New Deal s efforts to save American owned land and oil wells in Mexico from confiscation and exerted pressure on Washington to go even so far as to use the armed forces to make the diplomatic action effective Frequently do we hear business demanding police protection and working to secure a capable and effective police force

The Coast Guard and Custom Service maintained by the national government are also active in defending American business interests One of their very important duties is the prevention of smuggling in violation of the tariff laws Inasmuch as such laws are protections of the national market for American business smuggling involves a loss of that protection Smuggled goods on the market would compete directly and advantageously against both domestically produced goods and goods imported under the tariff What advantage would accrue to American textile interests if the tariff on Japanese textiles were not enforced with the result that such goods could appear freely upon the American market at low prices because the tariff had not been paid?

Government also frequently serves business by providing a free sales force for its goods A careful reader of a large metropolitan newspaper will no doubt remember having seen many times the instructions which have gone out from headquarters to the police force ordering the policemen to be courteous to out of town visitors to be reasonably lenient with out of town or out of state cars and to give directions The government is patently trying to attract such visitors or at least not to drive them away because they buy the services of hotels and restaurants and they give business to gasoline stations, theatres and other amusement centers and to the vendors of all kinds of articles from post cards to clothing

The Department of Commerce and the Consular Service also constitute a sales force maintained by the United States government to promote American business The former was expanded many times its original size and its appropriations were increased many fold during the secretaryship of Herbert Hoover And this was done with the enthusiastic approval and support of organized business interests in the United States The department built up an elaborate organization within the United States and throughout the world Offices were established in all important business centers The functions of these offices with their large personnel were

primarily two—(a) to make surveys of business conditions and report the information through the department to the business interests concerned and (b) to create so far as possible a market for American goods A great many surveys and investigations were conducted by the department in foreign countries at the request of the American business interests and much of the information in the possession of the department was available to interested businesses merely upon request

The Consular Service is a part of the Foreign Service of the United States It maintains officers in all large foreign cities and in all important business centers abroad The consul is a very important officer to any American business which is exporting goods to a foreign market or im porting foreign goods for the American market He performs many legal services on the spot He facilitates shipment of goods and keeps a careful eye on American business opportunities Through him the United States government tries to develop in foreign countries a favorable attitude toward American business He plays an important part in the negotiating of commercial agreements with foreign governments and foreign business interests and in so doing tries to protect and to enhance the opportunities and welfare of American business He gathers information about market opportunities sources of raw materials, developments in foreign com petition with American business and costs of production in foreign countries Both the Department of Commerce and the Consular Service are indeed important sales forces for American businesses and they are maintained from general revenues at no price equal to cost to the businesses being served Business is therefore receiving what amounts to a subsidy from the general public

The Bureau of Standards is another agency which helps American businesses With an expert personnel and with elaborate equipment for research purposes it stands ready to make investigations for businesses It has, for example performed research on the aero dynamic qualities of aircraft, on radio aids to aerial navigators on lightning equipment for airports on airplane engine problems and the strength of airplane joints and fittings on strength of building materials such as steel brick and cement, on the analysis of ingredients in dentifrices and on resistance of shoes and textiles to abrasion, wear and tear All of this work is done for the business concerned In effect, the United States government is main taining research laboratories and employing scientists to work for private bus nesses and this at less than the same work would cost if done by the businesses themselves

The present extensive development of commercial air transportation has been stimulated by and is to a considerable degree dependent upon governmental services A great deal of investigatory work is performed by the government and the results are disseminated for the use of the trade This work extends all the way from the scientific research of the

Bureau of Standards already mentioned to the publication of aeronautical maps and the furnishing of experts to advise local communities in the construction and development of airports Many physical aids to navigation are provided These include such things as the investigation of routes to determine those best suited for safe flying the construction and maintenance of intermediate fields for emergency landings the expenditure of millions annually to light and mark these fields and to erect and maintain airway beacons along the routes the development of directive radio beacons to guide pilots and the improvement of radio equipment for airplane communication along specified radio channels reserved for such purposes

In providing weather information the government is performing an indispensable service for the commercial air transport companies within the United States and to those maintaining Pan American trans Pacific and trans Atlantic flights The United States Weather Bureau originally made reports twice daily which was enough for ordinary purposes The needs of the aeronautical business were greater however and as a result of the rise of that business the Bureau expanded its services Additional meteorological and radio stations, supplemented by telephone and teletype facilities were established Frequent forecasts and warnings provide a constant source of indispensable information for airports and pilots

The United States Merchant Marine receives from the Coast Guard many extremely necessary and very valuable services These extend from the protection of shipping routes from icebergs to the enforcement of laws designed to further the interests of the American steamship lines Safety of life and property at sea is also the duty of the United States Navy which stands ready to protect American shipping any place in the world Today piracy at sea is non existent and its death knell was sounded by the rise of strong national naval forces Safety at sea appeals to both passengers and shippers Thus where the government provides this service the steamship companies are enabled to do a much bigger business than would otherwise be possible They are therefore dependent upon the government s indirect subsidies for much of their business because those subsidies stimulate ocean navigation

There would not be today in the United States the enormous market for automobiles busses trucks gasoline oil and rubber were it not for the highway system which has been constructed by governments at public cost All the many businesses involved in the automobile industry have a market or at least a wider market because the government has and is building and maintaining an elaborate highway system And those industries are well aware of their reliance upon government as is shown by their vigilant support of highway building programs

The United States Post Office runs an annual deficit which must be made up from general revenue The fact of the matter is that the postal

service is deliberately run at a loss in order to provide a subsidy to many interests which it serves some of them being business interests It is generally agreed that whereas the fee for first class mail produces a profit some other classes of the postal service which are devoted particularly to business use have prices which are fixed below cost The result is that the business interests which use these classes are getting service for which they do not pay full cost to the post office One such service performed by the post office for business is the carriage of advertising The low postage enables many businesses to advertise their services or products much more widely and at a much lower cost to themselves than would otherwise be the case The amount of advertising involved would probably be much more expensive in many cases if it were conducted through the newspapers magazines or by the employment of advertising firms and agencies Inasmuch as advertising broadens the market and creates a demand for goods, business sales are stimulated by the government at some expense to the consuming public A great number of businesses take advantage of this service which the post office offers and are therefore recipients of the subsidy It seems clear that organized business would not permit the government to change the rates upward and that any attempt to do so would fail in the face of strong business opposition In other words business wants this financial assistance

Newspaper and periodical publishers are the recipients of a similar subsidy The post office carries their products directly to the consumers at a postal rate lower than cost This service enables them to reach a much wider public at low cost to themselves which means that the government is enabling the publishers to make more profit because the amount of advertising which is the direct source of profit to publishers, is largely dependent upon circulation An increase on the latter frequently means an increase in the former The official rationalization of this subsidy accepted by both the government and the publishers is that the government is fostering public education by encouraging a wide distribution of information While this may be true the fact remains, nevertheless that the government is also helping the publishers

Another cause for the post office deficit is to be found in the franking privilege of governmental officers that is, their use of the mails at no postal charge presumably for the sending of governmental or official matter While the franking privilege is of direct benefit to congressmen themselves there is a fairly common practice which amounts to the grant of an indirect subsidy to some organized business interests by the post office This practice occurs where a congressman is predominantly sympathetic to a particular business pressure group, for example a trade association or where a congressman's constituency is dominated by a politically powerful business to which he owes his election In either instance he may use his franking rights to distribute the political propa

ganda of such businesses in great amounts and to great numbers of voters through the mails at no cost to the businesses he is serving The congressman who is using his franking rights in this way may start the service by offering it to the business group or the lobbyists of the group may approach him first At other times he may act upon his own initiative without any express agreement with the pressure group He knows however that the subsidy which he is providing will be desired or at least not disapproved by the group By whatever method the service is initiated the usual technique is for the congressman to make a short statement on the floor of his own house in Congress and then to ask and receive leave to extend his remarks The business propaganda is then printed in full in the Congressional Record at government expense This statement is then reprinted customarily *not* at the expense of the government and circulated as stated at full cost to the government

Government Aid by Direct Subsidy

Indirect subsidies do not exhaust the financial aids which government in the United States provides for business Government also provides direct subsidies for some businesses That is it gives them property and money

The transportation business has been particularly dependent upon these direct subsidies and in some cases today probably could not continue to exist without such help or at least could not maintain its services and profits at a scale anywhere near what they are In this field therefore many business men or security holders are the recipients of governmental relief almost as much as are the unemployed although no doubt the former would be the first to disagree with great indignation and vigor Knowing full well however their dependence upon governmental subsidies and desiring to continue them the recipients do not relax their efforts to continue and even to increase the government s gifts

The story of the building of America s elaborate and well developed railroads is a story of governmental subsidies the dependence of the railway companies upon that subsidy and the private fortunes accumulated by railroad pioneers partly by the aid of the subsidy system This story is largely an historical one and is probably so well known that it need only be mentioned here Suffice it to say that the continent was girded by rights of way upon land given outright by local and national governments to the railroads and with the use of government credit Also additional land of great value was given The companies often sold such land and thereby made considerable profit from the government s gifts Much of the money lent to the young railroad companies by the government was never paid back with the result that they were given money as well as land

The American merchant marine is today maintained and enabled to

compete with foreign merchant lines through governmental grants of both building and operating subsidies The present subsidy system is the culmination of a long fight in which American shipbuilding and shipping businesses have spent many thousands of dollars in lobbying and pressure on the national government to establish the practice of governmental gifts of money The rugged individualists in these businesses were willing to invest money in political pressure in order to reap profits from the federal treasury

As stated, the fight was a long one It did not reach success until 1928 This delay was due primarily to the opposition of shippers farmers and the Democratic party, all of whom opposed paying out of their own pockets to make gifts to the steamship lines so they could charge a profitable rate for carrying the products of business and agriculture to market It is interesting and of great significance to notice that success in this fight for federal subsidy was reached under an individualistic Republican administration of the twenties and continued with modifications by the collectivistic New Deal

But 1928 marks merely the recognition of a subsidy whereas from the end of the World War and during the twenties the government was actually maintaining an indirect subsidy This was done in the form of the sale to private shipping interests at a loss of vessels which the government built for use in the World War and which it owned The very fact that the companies could and did buy ships for far less than the construction cost, with the government bearing the loss meant that businesses were getting far greater value than they had paid for Also many of the vessels which were not sold were leased to shipping companies under operating contracts which virtually guaranteed the business men operating the ships from all loss and assured them a profit The difference again amounted to a government gift to business

The Jones White Act of 1928 provided a fund from which government money was loaned for the construction of ships It also granted a subsidy for the carriage of mail by paying much more than the cost of the service plus a reasonable profit In this scheme there is to be seen another cause for the annual deficit of the United States Post Office from whose budget the subsidy was paid

The government paid out to the American merchant marine business many millions of dollars Many reasons were used to justify this policy The subsidy would build up an American merchant marine to compete effectively with foreign merchant lines which frequently had lower building and operating costs and were subsidized by foreign governments It was said that American steamship lines should receive the business of other American businesses and that this could not happen without governmental support because of the competition of foreign shipping lines Also the supporters of the ubsidy system argued that the United States

needed its own merchant fleet to supply the foreign markets of American businesses during times of peace and war Finally the shipping lobbyists contended that an American merchant fleet was necessary to transport troops and supplies in time of war

That this subsidy system had failed to accomplish the objectives claimed for it by its supporters was shown by investigations made by a Senatorial committee and the Post Office Department They reached the conclusion that the mail contract subsidies had served only to enrich the private operators at the expense of the public and that practically none of the huge sums supplied by the government had been used to strengthen the merchant marine [1] The Post Office report declared

> The recent investigation has shown that comparatively little of the enormous grants has gone into the building of a permanent merchant marine on a sound basis
>
> The liberal treatment accorded to the operators under the ocean mail contracts has resulted in much waste and extravagance Too many of the contractors have directed these grants or subsidies or by whatever name this aid may be called to other than sound shipping operations Many of them have employed lobbyists and special representatives at enormous fees They have paid high salaries and excessive dividends In order to pipe these funds away from the mail contracting company they organized holding companies operating companies terminal companies agency companies stevedoring companies repair companies towboat companies and supply companies thus freezing out independent firms [2]

As a result of the disclosures of the operation of the existing subsidy system the government proceeded to make modifications—but did not abolish it Today there is a United States Maritime Commission which can and does grant both building and operating subsidies The rule the Commission is supposed to follow is to give enough money within maximum limits to meet the differences in ship construction and operation between the United States and foreign countries No longer does the post office incur a deficit by paying out millions of dollars to the shipping business for which it does not receive an equivalent value in service Again did American business men recipients of governmental aid fight for its continuance and today the American merchant marine is in business only with the financial support of the United States government

The development of the American airplane transport business was also made possible in large part by direct subsidy in the form of mail contracts The sums paid to these businesses also mount into the millions of dollars The United States government appropriated about twenty mil

[1] Paul Maxwell Zeis *American Shipping Policy* (Princeton University Press 1938) p 186

[2] *Ibid* p 163

lions during the Hoover administration for the carriage of the air mail During the fiscal years ending in 1931 1932 1933 (all of them Hoover budgets) $56 281 994 was paid by the post office to private companies under contract to carry the mail Of this total sum it has been estimated that $21 775 559 was in payment for service received plus a fair profit leaving $34 576 435 more than ten millions a year in pure gift to private business

The airplane industry and a good portion of the business world was in favor of this governmental subsidy Pressure was frequently exerted on the government both to get larger grants and to extend the subsidized air mail service The furore raised by the cancellation of the contracts in 1934 was only one expression of the demand for government help Likewise when the economy plan of the government in 1933 34 included a decrease in the appropriations for air transport subsidy many business forces concentrated their attention on Congress to prevent the cut from being applied Joined in this pressure for subsidies were other groups mostly sectional ones who wanted the air mail service extended to their local communities Local Chambers of Commerce cities and states tried their best to get air mail routes and stations and they did this with no regard to the facts that the amount of air mail business did not justify service and that the government would incur a loss by instituting it

Business Use of Government Credit

Closely akin to government aid to business by direct and indirect subsidies is that aid which many businesses receive through the use of government credit The government often uses its credit to provide for business financing for such purposes as new construction replacement of equipment and averting threatening bankruptcy The most important agency providing this assistance today is the Reconstruction Finance Corporation of the federal government This Corporation has been provided with billions of dollars during the short period of its existence which money it lends to such businesses as banks railroads and utilities By guaranteeing to investors the security of their principal by pledging its own unimpeachable credit it makes the capital available to businesses which might not be viewed as good risks by banks and thus could not get the capital they want without the help of the government

Eligible businesses have by no means been slow to avail themselves of this assistance Begun during the Hoover administration it had business support from its very inception Business protection during the life of the Corporation has successfully staved off incipient efforts to eliminate it or to terminate its lending activities It is well established today as is shown by the fact that it maintains a revolving fund usually in the hundreds of millions of dollars Debts which are paid back by businesses go into this fund which constitutes a source of capital for loans to other

businesses It is probably a safe observation to state that this agency gives every indication of functioning for an indefinite period in the future and this with business support Very likely its demise will come only when business no longer desires its services

To a large extent little business was not eligible for loans from the R F C in the beginning and since the need was just as great the little business men raised a clamor against the discrimination and against government help of that kind for only big business They wanted assistance also As a result of this demand which reached its culmination at a meeting of the representatives of little business in Washington held under the auspices of the United States Department of Commerce the government provided the same service for them Money was made available in smaller amounts at longer terms for a greater variety of purposes and with less stringent requirements for security required of the borrower So extensive was the desire of little businesses for the use of government credit that as soon as the machinery was set up the Corporation was flooded with petitions for loans and its officers kept very busy until the greater part of the need was satisfied

Unemployment Relief

Government relief whether direct or work relief for the unemployed and unemployables, is also a method of aiding financially some businesses Described as relief for the poor it is frequently forgotten by those not immediately benefiting that the appropriations constitute relief for business also In the first place business produces goods and services for a market and its economic success is dependent upon people being able to enter that market to buy the goods and services People without purchasing power are of no value in creating that demand for which business produces Also many consumers goods industries are dependent upon a market in which individuals buy but small quantities per person They therefore need a market in which there is effective purchasing power by many persons The ability of the low income class to purchase is of vital importance to such businesses because a very large proportion of the population of the United States is in the low income class Furthermore the money given out in any relief system is not too large for the living requirements of the recipients so that all of it is spent by them The fact that it is all *spent* means that relief money goes into the channels of trade It merely passes through the hands of the man on relief as a sort of conduit into the coffers of the grocery and the clothing business of the real estate business of the fuel and light business in fact of all the businesses which supply the goods which people need in present day society An employer is also aided by governmental unemployment relief because he then need feel no responsibility for the support of workers whom he dismisses Whenever he believes that he does not need a worker

he can fire him and let the government support the worker until he needs him again

In the case of work relief part of the relief money is spent to buy materials and that money goes directly into the businesses selling the materials without passing through an intermediary channel i e the hands of the worker In the case of the W P A a small percentage of the cost goes for materials whereas in P W A a larger share is spent in that way It should be clear that so called relief for unemployed labor is not limited to labor It is also relief for consumers goods industries medical and dental professions and for the businesses which sell sand gravel cement bricks steel and for many others

Many persons undoubtedly believe that all business men do not approve of unemployment relief and are working against such spending This belief is erroneous There is too much evidence to show that there is some business support for the continuance of such government aid These business pressures are probably of two kinds one to increase the size of governmental appropriations for relief purposes and the other to get for themselves a greater share of existing appropriations

It must be remembered that all business interests are by no means identical that the interests or desires of some business men conflict with those of others Consequently while it is true that many have taken a stand in favor of decreasing relief spending by the government some on the other hand have struggled to get more spending The author is in receipt of the very interesting information given confidentially by a lobbyist for a National Trade Association that there are in Washington lobbyists for other associations working to increase the relief appropriations

Probably the greater activity of the various business pressures however is in the attempt to get for themselves more of the money which is being spent It has already been pointed out how representatives of various constituent bodies of the United States Chamber of Commerce have worked o get more spending for themselves and for their localities They did this while at the same time favoring economy and a decrease in the spending It should be clear to anyone that this inconsistency tends to defeat all economy moves As soon as many different business interests press for more spending for themselves the whole force of their efforts is in the direction of a total increase Consequently while they may not intend to increase the total they are in effect exerting pressure to that end

Different consumer goods industries have supported government relief spending in the attempt to move surplus goods One recent example is the success of the textile industry in getting the government through the Surplus Commodities Corporation to purchase clothing which could not be sold because of the failure of purchasing power resulting from un

employment, for distribution to people on relief Another example comes from the organized grocery interests There have been many agricultural commodities such as eggs butter citrus fruits for which there has been no effective demand Yet many people have been doing without these foods because they did not have the money to pay the grocers price for them The plan drawn up by the grocers was for the Surplus Commodities Corporation a relief agency to make it possible for relief recipients to buy these surplus foods by an increase of fifty per cent in the relief money to be spent for food That is a person can use relief money to buy food stamps and for every two dollars he gets in stamps one dollar extra which is to be spent only for the foods declared to be surplus The cotton textile industry is at the time of writing urging that the same scheme be adopted for cotton goods People are going without needed clothing and other cotton goods such as bed sheets merely because they cannot afford to buy such commodities The industry is hard hit because it cannot sell its goods and the supply of cotton is thus exceeding the demand Consequently this business wants *this kind* of government spending for relief

The Controversy Over Economy

But it might be objected business men believe in and advocate governmental economy The answer is of course that the objection is perfectly correct Business men *do* want economy but they also want spending They therefore want inconsistent things What appears to be a confusion will become clear immediately upon remembering that all business interests are not identical A business man does want economy but he frequently wants that economy for the other fellow—for the other business or for the farmer—but not for himself The cry of economy is just like the talk of rugged individualism They are both raised against what the business man for any of a number of reasons does not want and forgotten at such times as the government is doing what he wants They therefore are rarely raised by a particular business man when the government is helping his business but always raised where the government is restricting his business or helping another business or coming to the assistance of agriculture of the consumer or of labor A good number to make a conservative estimate of the economy programs call for a decrease in the expenditures of government for social services or for aid to labor, but there is yet to be seen a demand by the automobile industry that the government economize in road construction, or in the shipping and shipbuilding business that the government economize by decreasing subsidies or naval construction by the airplane industry that the government economize by cutting the size of the national air force or by the munitions industry that the government save money by buying fewer weapons or munitions Attitudes toward government spending are

illustrated very well by a story Will Rogers told before his death Invited as a guest of Jesse Jones of the Reconstruction Finance Corporation to a dinner of the National Manufacturers Association the two men listened to many speeches made by leading industrialists demanding that the government get out of business and that it economize The story goes that Jones wrote after the name of each speaker the amount of money which his business owed to the R F C

The statement is frequently made that government relief and spending for unemployed persons is demoralizing and injurious to them It is said to destroy their initiative and independence If that contention is true it is indeed difficult to see why it should be untrue when the government is helping and giving financial relief to business Or to put it conversely if government aid and relief are not demoralizing to business men why are they necessarily so to other groups in our society?

CHAPTER 12

GOVERNMENT REGULATES BUSINESS

The demand that government should not regulate business is usually stated as a generalization It therefore presents the appearance of a demand by a united business world which appearance is very frequently deceptive Due to the fact that in most instances in the relations of government and business there are disagreements among business men the realistic analysis of any generalized business demand should involve a search to see *who* is making the statement and about *what* it is made Rarely is it said that the government should regulate another man s business or that the government should not interfere in my business in this particular way because I do not like it but should interfere in another way which I do like It should be apparent to all people that it is impossible for government always to satisfy everybody Because of the great number and the severity of conflicting interests and ideas in our society there is *always* support by some interests frequently including business groups and often opposition by other interests also composed in whole or in part of businesses

On the other hand the generalization is a strong one and does influence the attitudes of many people toward particular relationships between government and business It has come to have the force of a symbol in American political thinking The evidence is clear however that this symbol does not induce people to oppose specific governmental activities when they for any number of other reasons desire those activities Those who want the government to do something are not always prevented from demanding what they want because it is a form of government regulation of business

Government regulation of some businesses may aid other businesses For this reason whether a particular governmental activity is viewed as a regulation or as a protection of business may depend largely upon no more than the point of view The chapter preceding therefore is a study of some governmental actions from the point of view of those businesses which are protected or helped while in this chapter the point of view is that of the businesses which see a particular governmental activity to be restrictive or coercive Also included in this chapter are some governmental activities which take the form of restrictions on particular businesses but which are thought by those businesses to be protections of their interests

Regulation of Another Business

The most obvious business support for governmental regulation occurs in situations of conflict between various businesses in which regulation of the other business is frequently desired Accordingly governmental regulation of the rates charged and services provided by railway companies in the United States has had the support of many shippers both individuals and corporations Businesses are frequently the consumers of the goods and services of other businesses and as such they are no different than non business consumers That is they are both equally anxious to get the best quality possible for the lowest price they can coerce the seller to give

The original demand and political pressure for governmental regulation of the railroads probably came from the farmers who found themselves in many instances dependent economically upon the will of the powerful railroad interests but many industries later joined the farmers the interests of the two as shippers and users of railway facilities being identical The ruthlessness of the railway companies and the discriminatory practices such as rate rebates and grants of special favors to some business shippers over others all of which frequently meant that the welfare—if not the very existence—of many businesses rested upon the will of railroad executives influenced business shippers to demand governmental regulation of the railroads Consequently it was with the help of business that the Interstate Commerce Commission was established in 1887, and it has had the support of many businesses ever since Business shippers are frequently to be seen asking the I C C to regulate the railroads by decreasing existing freight rates by forbidding the railroads to increase rates when they desire to do so or by denying permission to withdraw a service upon which the railroad is losing money but which is necessary to the business shipper This governmental activity is the essence of governmental coercion During the depression the railroads sought to increase their income by a general rise in freight rates They therefore petitioned the I C C for governmental permission to increase existing freight rates by 15% At the hearings held by the Commission upon this petition the coal mining business argued strenuously against the requested increase primarily upon the ground that the higher rates would cost them many more millions of dollars annually to get their coal to the market

This governmental regulation however was not easily established against the opposition of the economically and politically powerful railroads They at first objected strongly to regulation which in their minds was socialism and radicalism of an extremely dangerous (to them) sort To the businesses supporting regulation and particularly to those which thought their existence was dependent upon regulation it was not socialism To their minds the government was merely helping business

At any rate, it took about twenty years to establish effective governmental regulation of the railroads and it is doubtful that it could have been done against the united opposition of all businesses and without the support of a considerable proportion of the business men involved in the regulation The support of regulation was too much for the railroad opposition and today the railroads no longer fight against it Also they gradually swung to support for the commission in order to get away from a competition which had become truly cut throat with rebates and rate cutting So chaotic had the competitive system become that it was often difficult for companies to survive The result is that governmental regulation of the railroads is firmly established today and that with the support of business This also explains why today the I C C is probably the most reputable regulatory agency in government and why it is rarely attacked by rugged individualists as a violation of laissez faire and the American Way

A governmental regulatory agency is by the very nature of the governmental process stronger more efficient and more capable where it has no opposition to fight it and make trouble for it Its activities will not be obstructed by such dilatory tactics as repeated court tests and by political pressure on legislatures or executives to induce them to intervene It is therefore more efficient in the sense that it can act more quickly and more effectively Methods of procedure can be established and followed because it does not need to fear that its regulations will be repeatedly attacked on the grounds of unfairness of the procedure followed in holding its hearings and issuing its orders

Also its personnel is more likely to be chosen with more attention to competence in the sense of knowledge of the work to be done This seems to be true because there being no great difference of opinion on policy among the groups with which the agency must work less attention need be paid to political questions in selecting the personnel The groups are accordingly more likely to agree upon any particular appointee to the agency thus eliminating long and disturbing political controversies over the filling of vacancies The men on such agencies can devote more time and attention to the technical problems of regulation and are relieved from a great deal of the political activity which they would be compelled to undertake if there were a regulated group constantly fighting against the regulations in the political arena This means that many an expert is available for such a regulatory job because he is not driven away from it by what is frequently to him the distasteful necessity to go through a political fight to get the appointment in the first place and subsequent political conflict in enforcing the regulatory laws Interest in the work to be done and the desire to see results make more experts willing to accept appointments Such to a ve v large extent, is the case with the

Interstate Commerce Commission today and this explains its very excellent reputation and firmly established position as a regulatory agency Its prestige goes back to business support for governmental regulation of business

Since 1935 the I C C has also had the task of regulating bus and truck transportation This regulation of business by government is stimulated by the fact that the truck companies use the public highways, for the construction of which they have not paid Their highway subsidy is advanced by state and local governments and by many taxpayers as grounds for regulation Trucking also causes considerable wear and tear on the roads thus increasing the costs to taxpayers for maintenance and is thought to increase the driving hazards for automobile owners Furthermore attempts at state regulation failed because of the interstate nature of the business

Originally there was no very great railroad interest in federal regulation of the motor vehicle industry since it was not a large one and did not offer great competition Many railroad executives thought that their business would gain because the demand for buses and trucks would increase the freight they would have to carry for the automobile building industry The attitude of the rail companies changed to support for regulation when the motor carrier business grew so rapidly that it made serious inroads upon the railroad business The depression accentuated the railroads loss of business to motor carriers in both passenger and freight traffic The loss in railroad passenger traffic has been estimated to be as high as 20 or 30% The loss in freight was about the same although it varied greatly depending upon the product carried the market supplied and the period during which the study was made For example trucks in 1929 in sixteen livestock markets carried about 22% and in 1931 33% In 1932 this was increased to 40 8% for seventeen markets This business was lost to a competitor who the railroads alleged was subsidized by the public construction and maintenance of a right of way They thought that this subsidization was unfair because they had to build and repair their own rights of way at their own expense, and even had to pay property taxes on them

The rates charged by the motor transportation business were always low enough to attract freight and as the depression became increasingly severe more business shippers took advantage of the truck services in the search for lower marketing costs The depression also caused more passengers to use cheaper transportation facilities Motor competition not only created a serious problem for the railroads but also called into question the whole established rate making system which the Interstate Commerce Commission had developed for the railroads Furthermore many shippers were using the lower rates offered by the motor carriers to force concessions from the railroads It is indeed little wonder that

the railway business looked to the government to regulate this competition

Some business shippers also wanted regulation This may seem surprising in view of the fact that truckers provided lower distribution costs but the reasons for this support are not hard to find In the first place the interests of all shippers are not identical Industries far from the market had to use the railway services and this put them at a disadvantage in competition with those shippers closer to the market who could use trucking Also competitors could not estimate the costs of distribution of each other with any degree of accuracy because there was no standard trucking charge They could not therefore decide within fairly well defined limits what price to place on their own products Railroad rates on the other hand are published and each shipper knows the transportation costs which his competitor must include in fixing the price of his own commodity In addition to these factors some shippers were probably concerned with the injury which motor competition was inflicting on the railroads Alleged opposition to governmental regulation of business did not prevent these businesses from wanting governmental regulation

Very early in the trend toward regulation the motor transportation business was strongly divided Some supported the demands for regulation while others vigorously opposed what to their minds was distasteful and thus an improper extension of government authority In general the passenger carriers have supported regulation This business is dominated by large concerns and the demands of large capital investment have eliminated the great number of small carriers from getting a start in the business so as to offer effective competition with the large and established carriers The trucking business on the other hand is intensely competitive It is carried on by a very large number of small concerns each working on a small scale It was estimated a few years ago that about seven tenths of all trucking was operated by persons who owned only one truck apiece Only a little capital was necessary for setting up a business and the struggle for freight was bitter Reductions in rates in competition for freight have frequently driven the profit out of the business and sometimes produced bankruptcy Many of the operators did not like this competition and desired regulation as a stabilizer in the sense that it would guarantee the rate to any carrier and protect him from the rate cutting of a competitor who wished to get his business As time passed the number of trucking companies to ask the United States government for regulation increased Support has probably never been unanimous however Some concerns have always desired the opportunity to get more business by taking it away from their competitors through lower rates Others no doubt, were opposed because of the conviction that government should not regulate business

Today therefore, there is regulation by the federal government through the Interstate Commerce Commission of the interstate bus and trucking business with the support and as a result of the demand of many businesses This regulation is very extensive and covers many activities To do business a concern must get permission from the Commission in the form of a certificate of public convenience and necessity The Commission also has authority to set the rates which may be charged to decide the conditions under which credit may be extended and to say how the joint rates between connecting carriers shall be divided The activities of brokers who get business for the carriers, discrimination between shippers, and between markets, the services to be provided by the motor companies are all subject to governmental regulation In addition, control is extended to financing and to the issuance of securities to consolidations of companies and to financial manipulations for the purpose of acquiring control of a motor vehicle company

The rise of the oleomargarine industry threatened the butter market of the dairy interests by providing a substitute for butter at a lower price thus appealing to the low income groups in the country In the desire for protection of their own market the dairy people asked the government for various kinds of restrictions on the sale of oleomargarine This was not done however without the opposition of the oleomargarine people who did not want the government interfering in business—that is, in *their* business and in a *way* which they disliked But, being smaller and politically weaker than the dairy interests, the oleomargarine people were unable to prevent some regulation although they did succeed in warding off what was to them the most dangerous and most injurious restrictions This superior governmental influence of the dairy pressure was probably due to the support of the dairy interests by the farmers who produce the milk of which butter is made of the governmental officers who eat butter and not oleomargarine, and of the middle and upper income groups who are more powerful politically than the low income class and who also are butter eaters Also the dairy industry was older and more securely established in our society

Accordingly statutes were passed by some of the state legislatures designed to drive the competitive oleomargarine off the market and thus to regulate the business out of existence They were not hindered in their activities by theories of rugged individualism or by talk about the alleged natural right to enter into and to conduct a legitimate business The way in which this goal was to be achieved was by making oleomargarine so repugnant that people would not buy it This is shown very well by the New Hampshire statute which required that oleomargarine be colored pink and which forbade its sale if colored in any other way The oleomargarine business turned to the courts and having lost the battle in the state legislatures they won the final decision in the Supreme Court of the

United States when such statutes were declared unconstitutional Other regulations were more successful They place upon the oleomargarine business certain requirements which it must follow in marketing its products State and national governments forbid the sale of oleomargarine colored to resemble butter and compel the business to market its products in distinctive packages and with clearly stamped information to the purchaser of the nature of the product The requirements are enforced by penalties in cases of disobedience

The effect of these regulations is not to destroy the business but merely to keep it from being as competitively effective as it could be if it were able to take advantage of the receptivity of the yellow color which years of butter consumption had developed in consumers and if it could sell its products in packages very similar to those in which butter was being sold Having again lost the legislative battle the oleomargarine industry again turned to the courts but this time with no success The United States Supreme Court sustained the regulations and they are now accepted by the regulated interests

The story of the enactment and enforcement of the anti trust laws is a story of the big business—little business conflict and of a demand by the latter for government regulation of the former Each of the present day anti trust statutes was adopted by Congress with the support of little business farmers and consumers The whole fight has been a struggle against Bigness, against the economic power of the giant industries which had developed in the latter part of the last century Farmers wanted lower prices Business men of the smaller variety objected to being undersold beaten by clever tricks or crushed to the wall by competitors with immense capital [1]

The combinations of businesses which were called trusts had been injuring small business men by virtue of the fact that their size and financial power enabled them to control production to regulate prices of commodities and to suppress small competitors Combinations were built up by absorbing, destroying or controlling enough concerns in the same business to dominate the field By 1888 many were under the control of such trusts as the Standard Oil Trust the Sugar Trust the Whiskey Trust the Cordage Trust the Beef Trust and the Diamond Match Trust Small business had to meet this competition and could be driven into bankruptcy at the will of the combinations Those which continued to exist did so only at the sufferance of the trusts which frequently desired to maintain the appearance of competition in the business even if it were an empty shell Little business wanted the government to break up the big concerns and to restore the status quo ante

A non economic source of support for governmental regulation of big

[1] Charles A Beard 'The Myth of Rugged American Individualism *Harper's Magazine* December 1931 p 17

business seems to have sprung from the attitude toward Bigness which was and is today quite widely held Many people believe that Bigness is inherently bad and the term big business is in many quarters an expression of condemnation Little business on the other hand is often considered to be inherently desirable It is difficult to explain why many people should possess such attitudes They may have sprung from the ideology of economic individualism which taught that competition was desirable Whatever the cause may be the important fact is that many people do possess these attitudes and act accordingly Therein rests some support for the anti trust legislation

The Sherman Anti Trust Act passed in 1890 by a Republican administration gave small business men their first victory This statute prohibited every contract combination or conspiracy in restraint of trade in interstate and foreign commerce Enforcement was to be by criminal prosecution of any such activity, by judicial orders forbidding future violations and by civil suits in which any person injured by an illegal trust could recover damages three times as great as the injury he had received

To get a law regulating business is only the first step Enforcement is another thing entirely Failure to prevent the regulatory legislation merely changes the forum of controversy from the legislature to the judicial and executive agencies whose function is to enforce the law If these authorities can be convinced that the law is unconstitutional if the officers are sympathetic to the groups trying to prevent regulation or if sufficient obstacles can be placed in their paths they can be played against the legislature A law which is unenforced or leniently enforced does not achieve much regulation It is possible therefore to avoid governmental controls even where they are established in the law and the pressure groups are well aware of this On the other hand the groups which want the regulation must not stop their pressure They must continue the battle for enforcement

The conflict between Bigness and Littleness therefore became one over law enforcement Many trusts charged with violating the law fought against regulation in the executive agencies and the courts and won many of their attempts to ward off governmental control much to the disgust of little business and of other groups which wanted the big fellows restricted In the first place the terminology of the Sherman Act was on the side of big business The breadth of statutory prohibitions the general nature of the words of the statute and the indefiniteness of its terms gave to the Department of Justice and the courts almost unlimited discretion in deciding whether a particular business had violated the law What is a combination or a conspiracy and when can they be said to be in restraint of trade ? What is an attempt to monopolize trade?

In the second place the Department of Justice whose duty it was to enforce the law was often either opposed or lukewarm Attorney General

Olney for example had been the lawyer for big business prior to his appointment and had successfully defended the Whiskey Trust against the government s anti trust prosecution He carried his big business bias into office maintaining friendly relations with his former clients and favoring attempts to repeal the Sherman Act at the very time his official duties required him to enforce the law He also failed to get a conviction in the Sugar Trust Case the one big case in which he appeared for the government and in his defeat he was pleased For the most part criminal enforcement of the law had never been very successful One reason for this failure was the fact that many Attorneys General disliked the idea of punishing business men for their business practices It was also very difficult to secure sufficient evidence to get juries to convict Probably basic to the failure of criminal enforcement was the sentiment of many people in the United States against looking at business activities as being criminal

The general tendency was to use the injunction against the trusts and to follow the practice of accepting consent decrees That is where a particular big business was charged with a violation it would promise the Attorney General to stop the objectionable practices and an agreement or plan for reform was accepted by both after negotiations between them This practice frequently left those who wanted regulation unsatisfied because they thought that many agreements for reform were too lenient and because the consent decrees did not change the trusts Enforcement was still necessary and the task of the Attorney General was left uncompleted Supporters of the law often thought that the government failed to enforce the consent decrees

A third reason for the failure to enforce the Sherman Act to the satisfaction of those who wanted vigorous governmental regulation of Bigness was the attitude of the courts They made decisions which effectively weakened enforcement In the Sugar Trust case the United States Supreme Court prevented effective regulation of trusts for many years by holding that the Sherman Act did not apply to combinations in manufacturing Until this decision was changed some years later in the Meat Trust case its effect was to permit many of the practices which it was originally expected that the law would stop In the case against the United States Steel Company many years later the Supreme Court showed that it was more interested in business than in vigorously enforcing the law Its reasons for the decision were based upon what the judges thought was good for business The meaning of the statute and enforcement efforts were still further confused by the Supreme Court s application of the rule of reason According to this rule the fact that a concern was so large that it dominated the business in which it was engaged did not bring it within the prohibitions of the Sherman Act For example in the United Shoe Machinery Company case the court permitted a

monopoly of as much as nine tenths of the business Under this rule neither the size of a concern nor the fact that it was restraining trade was enough to constitute violation of the law The restraint had to be unreasonable

Very clearly the rule of reason' meant that no one could know what big businesses were to be restricted and what not until the Supreme Court had decided There are no universally accepted standards of reasonableness Only that is unreasonable which a majority of the Supreme Court believes is unreasonable As a result of this rule only those activities of big business which a majority of that court did not like were to be prohibited

Whatever the intent of the court, another result of the rule of reason was the encouragement rather than the restriction of combinations—a result definitely disliked by those who wanted to see the trusts broken into small competitive units Because the size of combinations was not itself bad they could be formulated under the law In doing so the small independent concerns which had been united could be destroyed legally along with competition among them On the other hand, when small units wished to control or eliminate competition they could not do so because agreements for that purpose tended to be held to be violations of the law The original objectives of many supporters of the Sherman Act was thus frustrated Judicial interpretation of the Act encouraged the very Bigness which small business disliked

Discontent with the results of the Sherman Act led to demands for new legislation Again the pressure for governmental regulation of business returned the problem to Congress Little business farmers and consumers having failed to get what they wanted, decided to try again Accordingly the Wilson administration in 1914 adopted two new statutes, the Federal Trade Commission Act and the Clayton Act

The former statute set up a Commission whose duty was to enforce competition in industry and to act in the capacity of a group of experts to conduct investigations and to give technical assistance to the President Congress Attorney General and the courts It had no power to prosecute and to punish It could only compel the disclosure of information in its investigation and issue orders to a business to 'cease and desist in any practice which the Commission should hold was an 'unfair method of competition' The Commission was to become a sort of policeman for business to which other business men could go to protect themselves from the unfair practices of their competitors

The Clayton Act passed three weeks later was an attempt to remove labor and agricultural organizations from the scope of the anti trust laws and to cure the defect of broad and vague terminology As to the first, therefore the statute declared that labor was not a commodity and that the Act should not be construed to forbid the existence of labor unions

or their lawfully carrying out their legitimate objects These expres sions it soon proved were too broad and judicial interpretation of law ful activities and legitimate objects deprived labor unions of a great deal of possible protection under the Act

In attempts to clarify the anti trust laws four practices were specifi cally prohibited by the Clayton Act Business was forbidden to discrimi nate between customers by giving under certain conditions some lower prices than others to require a customer who wished to buy the busi ness s products for example a mimeograph machine to buy other articles that is paper and ink from the same concern rather than from another one to destroy competition by buying out ownership or control of a competing company and to use interlocking directorates that is where the directors of one company are also directors of competitors to stifle competition There was one weakness however which tended to destroy the attempt to inject certainty into the anti trust laws That was in the statement in the statute to the effect that the four practices were prohibited only when their use was such as to substantially lessen com petition or tend to create a monopoly in any line of commerce This terminology was sufficiently vague as to give the courts the same discre tion to weaken the degree of governmental regulation of business and to hamper the efforts of the little business men to get protection of their interests The fight for and against regulation was again transferred to the field of law enforcement

The Federal Trade Commission found itself burdened with a very difficult job Its task was to police powerful interests who did not want to be policed while at the same time other powerful groups insisted that the work be done Many small business men made complaints to the Commission and initiated its regulatory powers against competitors Thus the Commission found itself in a situation in which some businesses were urging it to regulate and coerce other businesses who fought against the coercion

The attitudes of the members of the Commission were of course im portant The breadth of its discretion in deciding what was unfair and what was in the public interest gave free play to the predilections of its members Accordingly many have been the conflicts over appoint ments to it Wherever a vacancy has occurred due to death resignation, or the end of the tenure of any Commissioner the pressures for and against vigorous regulation of competitive practices have been strong each trying to get its own candidate appointed and to block the appoint ment of the other side s candidate

The Wilsonian Commission was vigorous in its attack on the trust problem Its members had been appointed at a time when the support for anti trust regulation was politically strong Under the three Republican administrations of the twenties however the personnel of the Commis

sion was greatly changed and its attitude modified into a mild one It soon adopted the position that it should cooperate with business in the attempt to set up codes of fair competition rather than to coerce business This was called a policy of aiding business to regulate itself Also the former policy of giving pitiless publicity to unfair competitive practices was no longer followed These changes did not take place however without many protests There was still some support for governmental regulation of Bigness but the period of prosperity saw the country definitely big business minded and little business busy making money thus being more contented and less vigorous in its demands for the regulation of Bigness Also this post war and pre depression period saw the rise into power of trade associations as the spokesmen for all business To some degree therefore little business was deprived of its articulateness because these associations were quite generally controlled or dominated by the big units in the trade

With the coming of the depression however there grew a greater demand for more vigorous action Again was the personnel of the Federal Trade Commission changed and again has it become a more aggressive regulatory agency Also its powers have been increased both substantively and procedurally For example it was given authority to enforce its own orders instead of being required as was the case originally to go to the courts to get enforcement whenever any industry refused to obey its orders to cease and desist Also its substantive power over price discriminations was increased by statute

The Supreme Court often hindered the work of the Commission by decisions restricting its authority and creating a broad control over its activities In holding that it will not accept the Commission s decision of what is an unfair method of competition or of what is in the public interest the Supreme Court weakened the Commission by drastically circumscribing its discretion Broad judicial review of the Commission s procedure and orders means that the Commission has often been made cautious and slow in proceeding against particular businesses either upon its own initiative or upon the complaints of unfair methods of competition coming from another business because the Commission has no assurance of judicial support for its orders

Opponents of the anti trust laws have tried to weaken the Commission by demands for Congressional investigations and by statutory modifications The National Industrial Recovery Act the original idea of which came from big business was one such attempt It was designed to permit business to combine contrary to the anti trust laws and to develop codes of practices These codes were only an extension of the trade practice conferences desired by big business in the twenties and were drawn up and enforced by business organizations dominated by the big businesses in the industries for which the codes were made Little business

saw in the N I R A an evasion of the anti trust laws and strongly opposed It was pleased therefore when the N I R A was invalidated by the United States Supreme Court

In 1937 Congress passed the Miller Tydings Act to permit producers of trade marked or branded goods to require retailers to maintain the price set by the former wherever state legislation so provided This act permitted in a limited field a practice which had been prohibited as unfair by the Clayton Act Many businesses dislike this statute It regulates some retailers by making them subject to the dictation of large producers and it restricts the power of large retailers to compete with small ones

Subsidies May Lead to Regulation

Many times businesses which support or demand government subsidies or the use of government credit put themselves into the position of help ing to establish and maintain regulation of themselves whether they so intend or not Regulation may be the result of such governmental assist ance as a kind of price which must be paid to get the aid As already shown the highway subsidy was an important factor in the establishment of bus and truck regulation Government control over the merchant marine may be used as another example Steamship companies have frequently objected to observance of the regulations which accompany the money they receive from the United States government but their in sistence upon the continuance of the aid has put them in the position of helping to establish the restrictions

The United States Maritime Commission controls the labor policy of the companies receiving operating subsidies by the specification of mini mum manning and wage scales and the minimum working conditions for officers and crew The freedom of the employer in hiring officers and crew is limited by definite citizenship requirements The service to be provided and the routes to be followed by the subsidized lines are subject to the approval of the Commission It decides the specifications of ships to be built for the companies and subject to the limitation that the vessels must be constructed in the United States the Commission has some discretion over where and by whom the work is to be done Sub sidized ships are required to sail in the foreign trade and the operators are excluded from the operation of foreign flag vessels or from maintain ing any interests or ships in the coastal trade except with the permission of the Commission

Supervision over the financial affairs of the subsidized companies is also extensive Profits are limited to 10% and the expenditures upon which the profit is based must be justified The top salary of officers of subsidized operating companies is fixed at $25 000 per year and where the company owes the United States money for vessels the Commission may supervise the salaries of all the officers and employees Hidden ownership of subsi

dized steamship lines is forbidden, and they cannot maintain any pecuniary interest in ship supply or repair companies The Commission has considerable control over the relations of associated companies such as a holding company system Accounting and bookkeeping methods are under the supervision of the Commission Companies are required to maintain reserve funds for depreciation and replacement and for payment of the government s mortgages on their vessels Financial information must be filed with the Commission and all books are open to its inspection at any time

Other Aids May Amount to Regulation

Another way in which government regulates business is by helping one business interest to the disadvantage of a conflicting business interest The fact that business as a whole is badly split in many ways means that help given to one interest enables that interest to exist or to improve thus depriving the conflicting business interest of the advantage it would have were it not for the governmental action

There are many obvious examples of this Governmental construction of highways is a great help to the bus and truck transport people because it enables them to take business away from the railroads Thus are the latter restricted Governmental activity is a factor in regulating the volume of their business Financial aid to the railroads which keeps them from collapse amounts to the maintenance of a competitor of the bus truck, airplane and water transport interests, thereby controlling the amount of business they can do Business support for such governmental activities therefore amounts to support for governmental restriction on business

The tariff has already been discussed from the point of view of its aids to protected interests It must be pointed out, however that at the same time these aids work out in such a way as to injure other business interests which for that reason are opposed to the tariff system

In the first place, the importing businesses are frequently restricted by the protective tariff The higher price limits the market and therefore the tariff amounts to a regulator of the importer s volume of trade Take for example the tariff on foreign cameras, which protects the American market for domestic producers An importer and merchant of German cameras must pay a very high duty which means that he must charge a much higher price than the price of domestically produced cameras This reduces the market for the foreign product inasmuch as many persons who might like to possess German cameras do not buy them because they cannot afford or because they refuse to pay the higher price If there were no tariff duty the importer might be able to sell many more cameras Therefore, the tariff is tantamount to a governmental restriction on his business

Tariffs tend to reduce the volume of goods exported from the United States and thus to destroy potential foreign markets Exporting businesses therefore, are frequently to be seen objecting to high protective tariffs A nation must export its own products in order to be able to buy the goods of another nation In final analysis imports are paid for by exports For example when a foreign country sells goods and services in the United States credits are set up in this country with which to buy the goods and services of American businesses Therefore when tariff barriers in the United States prevent foreigners from selling us their goods they are deprived of purchasing power for American goods and services Tariffs which decrease the importation of foreign goods into the United States accordingly decrease the exportation of American goods to foreign markets

Goods are exported from the United States to be sold to people in foreign countries on the foreign market Their inability to buy means a loss of business to American exporters and the tariff has a great deal to do with their ability to buy In this world people must work and produce in order to be able to consume Therefore there will be more work in foreign countries, and consequently more purchasing power for some American goods if the United States imports foreign goods to be sold on the American market And the greater or lesser amount so imported will mean a greater or lesser purchasing power for the goods of American exporting interests The more a country produces the wealthier it is and accordingly the better market A poor country with a low standard of living does not make a good market

Another way in which the American protective tariff tends to restrict the business of exporting industries is through retaliation A tariff by the United States on the goods of one country may give rise to a tariff in that country on American goods It must not be forgotten that the tariff is an instrument of economic nationalism and experience shows that once it begins it is impossible to know where it will end

All of these results of tariffs are recognized by the New Deal Reciprocal Trade Agreement program The government is trying to place a brake on the isolationist and national self sufficiency drive to be seen in the world at the present time It is also trying to reduce the amount of restriction which the tariff system has placed upon American exporting and importing businesses by decreasing but not destroying the degree of protection given by that tariff system to those businesses which want the government to save the local market for themselves It ought not to be surprising therefore that these Trade Agreements should have aroused a great deal of controversy They have been praised by American businesses which have received greater foreign markets as a result of the Agreements and condemned by many business men whose tariff protection has been decreased

Businesses dealing in and people holding foreign investments are also

injured or restricted by the tariff system The more prosperous a foreign business is the more dividends it pays and the greater is the safety of the capital invested Therefore in so far as the tariff system decreases the exports of that business and restricts its market the less prosperous it becomes This means that it pays smaller returns to the holders of its securities and their saleability on the foreign security market is decreased The tariff system therefore tends to regulate the opportunities of investment businesses in the United States and the income of investors in foreign businesses

Some Businesses Want Government Regulation of Themselves

Some business men have asked and received governmental regulation of their own businesses This kind of business support for regulation has occurred where a group in a particular business has thought that regulatory action was necessary to save their business from extinction or to preserve its prosperity and the restrictions were accepted by them for such purposes

One of the best examples of a business asking for governmental regulation is to be seen in radio broadcasting As a new business it grew rapidly both in technical improvements and in the number of broadcasters in the field But the opportunities for doing business were not unlimited There are only twenty four hours in a day and technical considerations placed restrictions on the number of wave lengths which could be utilized It became perfectly clear therefore to those broadcasters already in the field that if they were to save their businesses it was necessary to get the government to regulate hours and wave lengths which broadcasters could use and to exercise the power to decide who could broadcast They decided that the government should issue licenses to broadcast the licenses to contain such restrictions and that the government should prevent anyone from broadcasting who did not have a license In this way was a potential chaos to be converted into order and at the same time (no minor consideration to be sure) their businesses were to be preserved Actually therefore they wanted governmental regulation of themselves in their own protection and against the interference of new broadcasters or of other broadcasters They wanted a regulation which virtually amounted to the grant of a monopoly on specified wave lengths at stated hours

If they had not acted when they did it is difficult to say in what condition the business would be today In the first place popular disgust might have developed over interferences by broadcasters with reception by using the same wave lengths at the same time and this reaction would have ruined the business or at least would have prevented it from reaching its present stage of development Or, popular discontent might have given rise to an irresistible demand for some kind of governmental regulation which could have been far more disagreeable to the broadcasters than that

which they now have By being the first to move for regulation they could keep a good deal of control over its nature and thus get only the kind of regulation they wanted Thirdly the result might have been governmental ownership and operation of broadcasting as a means of eliminating the conflicts which could have developed In any event the broadcasters already in the business and particularly the bigger ones had everything to gain and nothing to lose They were ready and even anxious for regulation long before Congress was ready to pass a statute providing for it

Herbert Hoover was an advocate of regulation As Secretary of Commerce he began as early as 1921 to license broadcasting stations much to the delight of the leading broadcasters He held conferences with them supported them in their efforts to get legislation through Congress and maintained close cooperation with them In 1926 however a court decision and a ruling of the Attorney General deprived Hoover of any coercive power holding that he could not deny a license to any broadcaster who asked for it The result was bedlam and the business men in the field renewed and exerted more vigorously their efforts to get legislation giving Hoover coercive powers in order to protect their businesses from new businesses In 1927 Congress was ready to provide for regulation but there developed a conflict as to whether the powers should be placed in the Department of Commerce or in a Radio Commission The broadcasters wanted the former but the Senate preferred the latter A compromise was reached by creating a temporary commission the question to be examined at a later time

Subsequently upon the question of whether the Radio Commission should be continued the broadcasters had to give in and regulation by commission was finally established In 1934 its powers of regulation were absorbed by the Federal Communications Commission to which power was also given to regulate communications by wire as well as by radio The only question to the broadcasters was *who* was to do the regulating and not *whether* it should be done Organized into the National Association of Broadcasters they unequivocally wanted to be regulated and did not stop fighting until they got it even if they had to accept it by a different agency than that which they preferred

The regulatory powers of the Commission today are very broad They include the authority to prescribe the nature of the services to be rendered by different classes of stations and to determine the location of stations The Commission assigns wave lengths power and hours of operation to the stations No station can operate without a license which can be denied, or revoked by the Commission, with court review provided Violations of Commission regulations are punishable The orders which the Commission can issue apply to such things as the kind of apparatus to be used the prevention of interference by one station with another the zones to be served by any station and the use of chain broadcasting The

tatutes specifically forbid censorship and require the Commission to protect the freedom of the air except that stations cannot broadcast anything that is obscene, indecent or profane and they must not give a monopoly to any one candidate in political campaigns

This power is a very extensive one and its exercise may have far reaching effects The mere fact that the Commission can revoke or refuse to renew a license has almost unlimited possibilities Short of that it is possible for the Commission to give a disfavored station undesirable wave lengths or hours The very existence of these powers and the possibility of their exercise by the Commission have made the broadcasters careful Consequently the censorship which now exists over radio broadcasting is that exercised by the business itself Many possible reasons can be given for this activity, but they all can be traced back to the regulatory power of the Radio Commission which the business itself invoked One reason is the fear that a program might be so offensive that the clamor of the owners of receiving sets to the Commission might result in the latter refusing to renew a license or to give very unfavorable conditions in the renewal A second reason is the fear that offense to the public or any large group such as a religious one might bring about pressure on the government to set up a vigorous censorship

While it is too soon to make any very thorough analysis of the work of the Communications Commission it seems clear that the Radio Commission did favor large broadcasters as against the small ones and commercial stations as distinguished from educational, labor and municipal stations The favored stations have had less to fear from the Commission than have had others To some persons therefore the story of radio regulation is a story of regulation of small and non commercial stations by large commercial stations The real reasons for this favoritism are undoubtedly greater political power rising out of size support by advertisers and the indifference of the general public and the frequently superior technical performances wave lengths and hours of the former

Regulation of Employer Employee Relations

In the field of employer employee relations a great many business men want governmental interference and frequently exert efforts in many ways to get the government to act They do not want the government to keep out of this field They do not want to stand on their own feet and to depend on their own initiative and ability to protect their own interests from the demands of their workers In no other phase of the relations between government and business is the profession of business men that the government should keep its hands off business more often violated

Of course they do not want just any kind of governmental action in this field any more than they do in any other field What employers want

is governmental regulation which they believe is protective of their interests In other words they want the government to intervene on their side and against the efforts of labor unions to get what they want The fact is therefore, that they want the government to intervene and not to let them alone to face their organized workers unaided This amounts to a desire for governmental regulation of employer employee relations

And business makes this desire articulate by demands for governmental action and by pressure to get it Even before they have a labor dispute many employers support legislation to regulate picketing to fix the conditions under which strikes can or cannot be called such as requiring a notice of thirty or sixty days or of some other period to forbid strikes to outlaw boycotts to incorporate unions to make them civilly or criminally liable for many of their actions which the employers find disadvantageous, and many others

As soon as a strike or other dispute arises they demand governmental intervention to prevent the strikers from using any superior force which they might have to win their demands but not to prevent employers from using any superior force they might have to deny to the workers their demands They ask the government to intervene through its courts to enjoin the strike or picketing If that is impossible they ask for injunctions to regulate the kind of picketing that can be conducted by the strikers or the number of pickets they can use They also demand that the government use its police for similar purposes

In American history there are some extreme cases of some businesses getting the government through courts police and even the army, to break up and stop workers from striking One such a case was the Pullman Strike in Chicago at the end of the last century The company did not want the government to keep out and to let the company fight the strikers without help The Pullman Company asked for and received an injunction declaring the strike illegal Subsequently it induced the government to use the United States Army to stop the strike with force A more recent case was the strike in the spring of 1937 at the Republic Steel Company s Chicago plant At that time the company approved the intervention of the city s police force which broke up the strike

In trying to get the government to regulate their relations with employees many times employers through their lawyers convince the courts and police that existing laws should be interpreted in such a way as to restrict their striking workers And it is immaterial that these laws were originally enacted for completely different purposes or, at least with no thought of labor troubles One example is the use of the laws against vagrancy to imprison labor leaders or organizers Another is the application to pickets of municipal ordinances against loitering or obstructing traffic, thus trying to get the government to intervene to break up picket

lines or at least to make them less effective Another example of this business insistence upon an approval of governmental regulation of business through judicial interpretation of existing laws is to be seen in the United States Supreme Court s application of the anti trust laws to labor unions It was in suits brought by business men and upon the arguments of their lawyers that the judges were induced to make this interpretation

CHAPTER 13

PUBLIC UTILITIES

Ideas on the relations of government and business have tended to approve governmental control of certain industries which are said to be affected with a public interest Thus there is another exception to the generalization that government should not regulate business The approval of regulation is very widespread and often the regulated industries them selves support the notion

The attitude in favor of regulation rests upon many grounds No doubt many people have been conditioned to a way of thinking accepted by their environment and governmental regulation has become traditional It is now accepted as a matter of course Also the industries classified as public utilities are thought to be providing services vital to the consumer who should be protected from exploitation Frequently the industries are per mitted or required to maintain monopolies and because of the absence of competition must be regulated to prevent them from exploiting their consumers A common attitude is that competition is desirable as a pro tection of the consumer but that the public utilities can provide better services without competition The protection must therefore be provided by governmental action Another basis is the idea that the public utilities receive many special privileges and grants from the government and should therefore be required to surrender some of their freedom in return for the special status which the government has given them Consumers often approve the regulation of rates and the requirement that certain standards of service be maintained by the business They view regulation to be in their interests Investors also feel the need for regulation of financial practices and want the government to require the industry to follow certain standards which are designed to protect their investments from risk at the hands of management

Many industries which are classified as public utilities also often ap prove the idea of regulation even though they may fight against specific controls or against enforcement of particular regulations Very often they cannot avoid the action of government because they are too weak politi cally to do so They may find that the better policy is to accept the idea and to try to control the direction and kind of regulation which may be attempted The tradition that government should regulate public utilities no doubt often motivates their thinking and action as well as that of others There may be controversy whether a particular industry is a pub

lic utility but not whether it should be regulated if the question is decided in the affirmative Another factor influencing industries to accept the idea of regulation and often even of specific regulatory acts is the fear of and the desire to prevent government ownership and operation

What Industries Are Public Utilities

While not disapproving of the notion that government should regulate public utilities many industries object to being cla sified as such If they are successful they can ward off the kinds of governmental regulation which they do not like The controversy over classification is therefore often merely an instrument to avoid or to establish particular procedures of regulation

Whether a particular business is 'affected with a public interest' and thus subject to the regulatory procedures and techniques which have been held to apply only to such industries is often a very controversial ques tion The first determination of the issue occurs in the legislature which makes provision for regulation but the final decision rests in the courts Here the judges have considerable discretion No definition that has ever been offered is conclusive or decisive The concept of the public utility is an esoteric legal concept

The classical definition was made by Chief Justice Taft of the United States Supreme Court The circumstances which clothe a particular kind of business with a public interest must be such as to create a peculiarly close relation between the public and those engaged in it and raise implications of an affirmative obligation on their part to be reason able in dealing with the public The Chief Justice divided such industries into three groups

(1) Those which are carried on under the authority of a public grant of privi leges which either expressly or impliedly imposes the affirmative duty of rendering a public service demanded by any member of the public Such are the railroads other common carriers and public utilities
(2) Certain occupations regarded as exceptional, the public interest attaching to which recognized from earliest times has survived the period of arbi trary laws by Parliament or Colonial legislatures for regulating all trades and callings Such are those of keepers of inns cabs and grist mills
(3) Businesses which though not public at their inception may be fairly said to have arisen to be such and have become subject in consequence to some government regulation They have come to hold such a peculiar relation to the public that this is superimposed upon them In the language of the cases the owner by devoting his business to the public use in effect grants the public an interest in that use and subjects himself to public regulation to the extent of that interest although the property continues to belong to its private owner and to be entitled to protection accordingly[1]

[1] Charles Wolff Packing Company v Court of Industrial Relations of the State of Kan sas 262 U S 522 535 (1923)

An analysis of this definition will show its failure as a guide and this in fact was admitted by the Chief Justice in his opinion Some industries have been traditionally considered to be utilities and about them there is no dispute Some examples would be bus lines railroads gas and electric power companies On the other hand it is possible for a particular business to lose its characteristic as a utility Just when that happens we are not told The real indefiniteness and trouble however, arises upon the third class which includes businesses which have not traditionally been considered to be utilities but which have become so Again there is no definite guide upon which to determine the time of change

Most controversies have arisen under the third classification and the court s discretion has been practically unlimited in deciding the characteristic of the industries in question Accordingly the courts have held that the ice business theatre ticket agencies employment agencies and the meat packing business were not affected with a public interest On the other hand the renting of homes and apartments in Washington during the World War was regulated with the permission of the court Also telephone companies and stockyards have been classified as utilities by some courts Very often different courts have differed the judges themselves finding that the judicially created guides were of little value Legislative decisions that the businesses were affected with a public interest were overruled by the courts in the former instances but not in the latter

There has been a great deal of criticism of the concept of the public utility and among the severest critics have been some members of the United States Supreme Court Mr Justice Holmes for example went so far as to call the concept a fiction Until 1934 however objections to the concept seem to have been unavailing In that year the majority of the United States Supreme Court deprived the term of any significant meaning in Nebbia v New York Mr Justice Roberts in the court s opinion declared The phrase affected with a public interest can in the nature of things mean no more than that an industry for adequate reason is subject to control for the public good In several of the decisions of this court wherein the expressions affected with a public interest and clothed with a public use have been brought forward as the criteria of the validity of price control it has been admitted that they are not susceptible of definition and form an unsatisfactory test of the constitutionality of legislation directed at business practices or prices But there can be no doubt that upon proper occasion and by appropriate measures the state may regulate a business in any of its aspects including the prices to be charged for the products or commodities it sells [2] This decision seems to deny that so called public utilities are in a separate category for special treatment by governmental regulatory activities

[2] Nebbia v New York 291 U S 502 536 537 (1934)

It is too early to say whether the Nebbia case marks the end of the legal concept of the public utility One important fact is the failure of the court to explain definitely the status of its preceding cases in which that concept was accepted Also four justices wrote a very vigorous dissenting opinion which may carry considerable weight in the future Therefore any court in the future may ignore the Nebbia case explain it away or resort to the other cases which seem to be in conflict with the Nebbia case This case however has been followed recently by the Supreme Court of New York in preference to a previous case which the judge said had been overruled The New York court upheld state regulation of the rates of ticket agencies under the authority of the Nebbia case and in disregard of a previous decision which had held that theatre ticket agencies were not affected with a public interest and thus not subject to a legislative regulation of rates It seems quite clear however that whether the concept is abolished by the court or not the Nebbia case does not eliminate the court s power to control the legislative regulation of business For example before the Nebbia case the courts could restrict legislative discretion in regulating industry by holding that a business was not clothed with a public interest and since that case the courts can accomplish the same results by ruling that the occasion for legislative action is not proper or that the legislative measures are not appropriate

Methods of Governmental Regulation of Public Utilities

Previous chapters have shown that government coerces regulates and helps all businesses in a great number of ways No business can be immune from governmental regulation In view of these facts it may seem pointless to quibble over whether an industry is or is not a public utility Whether it is classified as such or not it is obviously regulated by government

The question at issue is not therefore whether the government can regulate It is one of the ways in which or the procedure by which regulation occurs That is, the legal concept of the public utility provides that only industries of that character could be required (a) to get specific governmental permission in order to be able to do business (b) to maintain the standards of services specified by a regulatory agency of the government (c) to charge the rates fixed by the governmental agency as being fair (d) and to keep records in specified forms which records are subject to governmental inspection Consequently the controversy over whether a business is a public utility or not is a struggle for and against particular procedures of regulation and not simply for and against regulation It has often been necessary for those people who wanted particular methods of control exerted over certain industries to maintain their classification as public utilities in order to accomplish their desires The failure to get the classification approved by the courts prevented the satisfaction of their demands On the other hand a business which did not

want that particular method of procedure could often prevent it by con testing successfully the classification in the courts In reality however a great many businesses are regulated or coerced as to some of these respects by governmental action even though they may not be thought to be public utilities

Most of the supervision of public utilities is a state matter rather than a national one A trend toward a transfer of activities from state to na tional government is noticeable however and the objection of utilities to the transfer has been thought by some authorities to be a factor in the strengthening of state power That is fearing federal more than state action utilities have often ceased blocking state action and have even helped to make it more effective in order to prevent national action The administration of the powers and the application of the controls is usually vested in commissions Legislatures establish the regulations and then set up organizations to apply them For the most part today these agencies are called Public Utilities Commissions or Public Service Commissions Sometimes there are more specialized agencies with different names but the commission form dominates Regulation is a full time task and often requires a specialized training or experience The work is complex and technical The administrative commission satisfied these requirements

(a) Permission to Do Business

In a business classified as a public utility it is generally necessary to get the permission of the government before one can offer his goods or services to the public This permission is granted by an order which con fers the right to do business and is granted upon an application for it This order is usually called a certificate of convenience and necessity or a franchise Sometimes the term license is used As a general rule the fran chise is distinguished from other forms by the fact that it grants the right to use public property such as street or highway

Permission is granted or refused upon the determination by the appro priate governmental agency that a company can and will grant satisfac tory services to its consumers and that the service is one which the consumers need and which will add to their convenience Factors often considered in public convenience and necessity are financial condition of the company modern and safe equipment experience and reputation of the men managing the business and general impressions of the likeli hood of satisfactory relationships Competition is also an important factor For example if one company is already providing the service do the consumers need another company? Competing companies may mean dupli cation of equipment and of facilities such as two bus lines on the same street two electric power or telephone companies resulting in greater costs and overhead and interference with the efficiency of the services Compe tition is often thought to be wasteful Possible rates to the consumer are

also a factor in the consideration of petitions for certificates of convenience and necessity A commission will be favorably impressed by a company which can show that its equipment experience and financing are likely to enable it to provide the consumer with services at lower costs than might another company Monopoly may mean lower prices if subject to careful regulation of its rates because it eliminates the duplication of facilities and permits uniform production and marketing of goods and services A competitor may be permitted to enter the field however if the commission believes that the needs of consumers are not being satisfied by the operating company or if it believes that the competition will not cost the consumer more for the services or create confusion in the utilization of the services

The certificate of convenience and necessity is a powerful instrument of control the exercise of which may or may not be liked by the utilities themselves In the first place a company which can not get the certificate would be prevented from doing business but the one already possessing permission is protected from potential competitors And there are many examples of this conflict Laws providing for the necessity of certificates are often attacked by businesses which do not possess but which want to receive the permission to do business At the same time other industries which have received permission defend the laws Concerns already established often go to court to get injunctions to restrain other companies from doing a business which competes In other words certificates are often very valuable property rights which the government gives to some business men and which they defend just as they would any other property right On the other hand the possessor of a certificate is also controlled in some respects In some states he can not expand or extend services without getting additional certificates Most states, however do not impose this restriction Also it is fairly common to forbid the possessor to transfer a certificate to another company without permission The objective of such restriction is to prevent speculation in certificates Being valuable property rights business men might be tempted to buy and sell in the attempt to make a profit regardless of the fact that the certificate is a governmental grant and that consumers and investors might be greatly injured thereby Another factor making for control is the revocable nature of the certificate The fact that the commission might deprive a company of its permission to do business is a coercion upon it The existence of the power to revoke, suspend or to alter a certificate often means that the company feels pressure to maintain its services and give satisfaction as a condition necessary to its existence In this way consumers are given an added governmental protection Finally a company which holds a certificate may be prevented from discontinuation of services The standards upon which decisions on discontinuation are made are the needs of the consumers for the services of the company and the need of the companie for a profit

Usually, a concern can be required to provide a service even though it is sold at a loss so long as the entire business done by the concern does not produce a loss The Supreme Court of the United States has often held that even if the company does not make a fair return on all its business and a loss on some of it the concern must continue operation unless it is willing to abandon its certificate entirely

The commission of course need not apply all these controls upon the possessors of certificates In fact it is safe to say that in most instances the certificate is more of a protection to the utility and a kind of governmental subsidy than it is a regulation

(b) Regulation of Standards of Service

Public utility commissions have the authority to specify the quality and quantity of services and require the companies under their jurisdiction to meet these standards The objective of such authority is to protect the interests of consumers by guaranteeing that their needs be adequately provided for Estimates of consumer need therefore are the bases upon which this method of action is supposed to rest The quality of service involves such factors as purity of the water and gas provided by water and gas companies and the safety speed and promptness of transportation facilities furnished by bus and trolley lines and by the railroads The quantity of the service involves such factors as sufficient and constant pressure of gas and water the constant voltage of electric power and the supply of rolling stock at often enough periods to meet the demand The quantity required by consumers may vary at different periods of day and night and the company therefore is not ordered to maintain the same amount of service at all hours The utility is permitted to decrease the quantity in accordance with the volume of demand at the appropriate periods

As a matter of general practice these regulations are not burdensome upon the companies which are subject to them All industries normally try to produce as much as they can sell at a particular price and not any more than that amount The regulations are merely estimates of the amount and are usually made by the cooperative efforts of both the company and the commission rather than by the former alone Furthermore if the services of the utilities are maintained at high quality the consumers are given greater satisfaction which reacts to the advantage of the companies themselves by providing them with the support of a satisfied market

(c) Regulation of Rates

Commissions also have the authority to specify the rates to be charged by the industries under their jurisdiction Competition frequently being absent the regulation is designed to protect the consumer from exploita

tion, which protection competition is usually thought to give Oftentimes even if competition is present there is fear that the concerns might avoid it by agreements on prices and the consumers thereby be forced to pay unnecessarily high prices On the other hand the consumers are held not entitled to the services at such low prices that the industries are injured The basis therefore of price regulation is the rule that the rates must be sufficient to provide a particular utility with a fair return on the fair value of its property devoted to the public service This rule is a legal one created by the courts out of their interpretation of the due process of law clauses of the United States Constitution It is said that a concern which does not receive a fair return on the fair value of its property is being deprived of its property for a public use without sufficient compensation and without due process of law

The first step in determining rates is therefore, the estimate of the value of property The difficulties in the path of the performance of this function cannot be exaggerated Ordinary standards of value do not apply Frequently the industry is not a competitive one and thus standards of value in competitive businesses are not applicable Also there is no steady market for the property which can be consulted at any time to find a market value In fact the property probably has no or very little market value Its value rests upon its production and its performance of services and not upon saleability

The courts have tried to set up certain standards or elements upon which the process of valuation must be based In the eyes of many authorities and students of public utility regulation the courts have succeeded in doing no more than confusing the subject or at least of not providing any solution Inasmuch as the process of valuation is the first step in rate making the task of such regulation tends to be frustrated from the very beginning

The Supreme Court of the United States tried for the first time in Smyth v Ames in 1898 to specify the factors which constitute value The court said that consideration must be given to (a) original cost of construction (b) the amount spent in permanent improvements (c) market value of stocks and bonds (d) the present as compared with the original cost of construction (e) the probable earning capacity of the property under prescribed rates, and (f) the sum required to meet operating expenses The court did not specify any weight to be given to particular items nor are other items to be excluded from consideration

This uncertainty of the weight to be given each item is one of the reasons explaining the inadequacy of the standard of valuation set up by the court Different experts will differ in their opinions of which items to stress Also as economic conditions and as the purchasing power of money changes, different groups tend to emphasize certain items over others For example, as prices of labor and materials rise the utilities stress the re

production cost item but the advocates of low consumer rates tend to urge greater weight for the original cost item The contrary is the case in periods of decreasing price levels Changing economic conditions and price levels also add an impermanent character to any particular valuation It can easily be seen that because of these changes any particular valuation which is held fair under the price levels at the time might be thought to be made unfair at a later time by the changed levels

Another reason for the unsatisfactoriness of the standards of evaluation is the entrance into valuation procedure of the concept of the going concern That is in estimating the costs of reproducing the company it is held that the concern is composed of more than buildings machinery property et cetera It is also valuable as an operating business Thus even assuming that there are ways of evaluating the tangible items with some degree of certainty and uniformity among experts the added intangible factor involves no more than pure guess or discretion At times about all that can be done is to estimate the value in terms of the tangibles and then add some fraction of that amount for the going concern value Experts may differ millions of dollars in the case of one utility upon this one item alone

Evidence of the inadequacy if not the meaninglessness of the standards upon which the process of evaluation is based is provided by the wide variations to be seen in the results of the work of the experts in evaluation and appraisal Men who are well qualified and reputable and who use the same inventories often reach conclusions which vary many millions of dollars In the New York Telephone Company case in 1925 the following estimates were submitted

Majority of Commission	$ 366 915 493
Statutory Court	397 207 925
Minority of Commission	405 502 993
Master s report	518 109 584
Company claim based on Wittemore appraisal	528 753 738
Company claim based on Stone and Webster appraisal	615 000 000 [3]

Once the figure for the value of the utility s property is accepted the next step is to fix the price of the services of the company to the consumer at a figure which will provide a fair return on that property There is no one percentage fixed as fair This also is a matter of discretion and upon which there can be legitimate differences of opinion among the experts A rate of return very commonly accepted as being fair is 7 or 8% The factors which are supposed to be considered in establishing the rate are such as the degree of risk involved the rates of return upon other invest

[3] William E Mosher and F G Crawford *Public Utility Regulation* (Harper & Brothers 1933) p 202

ments the inducements to investors to put their money in the utility, and provision of sufficient funds which the company can use to maintain reserves meet the required standards of service and provide for needed replacements and expansions of equipment

It should be obvious of course that the higher the valuation the higher the prices to the consumer and the greater the income of the utility Public utilities therefore usually strive for higher evaluations of their property High returns do not always benefit the investors because often their securities may be highly inflated potential profits may not be converted into dividends but put into reserves or drained off by holding companies or by management in the form of salaries and bonuses Also high returns mean greater costs for the consumers Very often therefore these groups and those people who are interested in protecting them are to be seen to struggle to secure lower evaluations In other words, the establishment of the fair value of the property of a public utility is the crux of rate regulation

(d) Regulation of Financial Practices

Closely associated with the foregoing procedures of regulation is the control vested in the commissions over the financial practices of the industries under their jurisdiction Supervision over the issuance of securities over borrowing over the standardization of financial records and the inspection of those records provides information upon which the control over services and rates are to some degree dependent

This control is by no means complete Many state laws do not vest sufficient power in the regulatory agencies But even when sufficient power is provided by statute the device of the holding company often prevents the effective exercise of the power The holding company system may cover more than one state with the result that it is outside of the jurisdiction of any one state regulatory agency

Experience of the Government in Regulating

The adoption of the commission form of control of industry in the respects briefly described was viewed with considerable optimism by some people interested in the subject of public utilities The application of the techniques and procedures of regulation by commissions has been described as the 'final goal' It has been said that the day of the interference of politics in regulation was past and that the time had come for action by experts who have broad powers and who combine scientific research with non political administration and thereby reach a 'sound public policy'

It is needless to say that this optimism was premature Administrative commissions do not work in a vacuum any more than do other governmental agencies All must work with people must do things for and against

people and thus must face pressure and conflicting demands which may influence their activities In actual fact the experience of the commissions has been influenced no end by the pressure of the groups whose ideas and interests are affected by the regulatory process Public utility and associated interests have had a great influence in preventing the kind of regulation they disliked and in directing the regulation into more favored channels The primary forces in support of the specific techniques of control have been the people interested in investor and consumer protection Of the two the former has undoubtedly been the more significant influence Consumers are often unconscious of their own interests are ignorant of the issues involved in regulation have less powerful associated interests and are unorganized Important factors in restraining the efforts of the opponents of particular controls have been the fear of government ownership and operation and of federal action if the efforts of the states fail Public utilities often find it more advantageous to acquiesce and accept some controls rather than to create the dissatisfaction which constitutes a fertile field for kinds of governmental action which would be made more distasteful to them than that which they do accept The actual experience of the regulatory commission therefore has been the result of the combination of forces which control all the relations of government and business In this respect as in others the relations of the so called public utilities with government is similar to that of the relation of all businesses with the government

In this conflict of forces the record seems to indicate that the dominant influence on the control has been the public utilities and associated interests They have often been able to direct the control to ward off the more disagreeable kinds and in general to make the experience of the government different than that predicted by the optimists

Many techniques of exerting pressure have been used Often adequate and effective legislation was prevented The result has been that often commissions have found themselves without sufficient or without uncontroversial power to act Frequently appropriations for the public utility commissions have not been sufficient to enable them to do effective work Their staffs have often been limited in size by a lack of funds Also the personnel of the commissions have often been people friendly or sympathetic to the utilities which have been very successful in preventing the appointment of officials to whom they were opposed In this way the utilities have often exerted considerable influence upon the policies and the aggressiveness of the governmental agencies which were set up to regulate them

This story is much the same as that of the conflicts over all governmental regulation of business in fact all relations between government and industry Failing to prevent the adoption of regulatory policies (in this case the classification of the business as one affected with a public interest)

they turned to efforts to direct the enforcement of the controls and the administration of the regulatory machinery The creation of the administrative form of procedure merely transferred the political conflict from the legislature to the commission In case that failed, as it no doubt often did the utilities could and did turn to the courts If an objectionable decision of a case could not be prevented or if a desired decision was not granted the company could and often did drag the controversy into the courts Thus a defeat before the commission often turned into a victory in the courts This has been particularly true in the case of regulation of rates and the chaotic state of that process played into the hands of the utility which was fighting against the adoption of particular rates As a matter of fact this judicial control over rate making resulted in the adoption of the policy by many commissions of specifying rates only after conferences and agreement with the companies Thus only those rates are made which the companies accept Governmental regulation often came to mean only that governmental action against which the companies did not wish to fight This policy was adopted not simply on the ground that the courts would be likely to reverse the commission s decisions because of the chaotic condition of the standards of rate making but often because the commission knew that the controversy could be so protracted and so expensive that even if the courts should sustain the commission the consumer would still be the loser

Other difficulties in applying the procedures of regulation also weakened the regulatory machinery One of these difficulties arises from the growth of the holding company system State commissions could not prevent the formation and development of large holding companies in the public utility field and could not control them afterwards Under the holding company too many aspects of the utility business were outside the jurisdiction of the states An industry may not be physically local but the regulatory agency is This is particularly true as to the financial characteristics and the financial structures of large utility systems Inability to exercise adequate supervision over financial practices diminishes the ability of the commission to protect investors to supervise adequate standards of service for consumers and to acquire information upon which to estimate the rate base Another difficulty was the inability of the commission to control wholesale prices Rate making is essentially a matter of retail prices Thus where a utility buys electric power from a large system and then distributes it to the consumer the wholesale price is an important factor in the retail price Failure to control the wholesale price means less influence upon the rate structure Still another factor affecting the effectiveness of the regulatory procedures was the difficulty presented by the absence of definitive standards upon which action is to be based This defect has been illustrated previously by the description of the factors in evaluation of property for rate making purposes

These sources of influence upon the conduct of the regulatory agencies of the government have led to dissatisfaction in many quarters In turn this dissatisfaction in recent years has served to influence two noticeable trends One of these trends is a slight increase in federal activities In addition to the well known and well established Interstate Commerce Commission the national government has been expanding in the field of ownership and operation of electric power companies as seen in the Tennessee Valley Authority and in the Western power projects The Public Works Administration has stimulated the growth of municipal electric power companies by loans to cities for construction purposes Other examples of federal activities having a regulatory effect upon public utilities are the Federal Water Power Act the Public Utility Holding Company Act the Gas Act of 1938 and the Federal Communications Commission Act Another trend in recent times is the strengthening of state control by curing the defects in state legislation and by increasing the authority of the state commissions As already stated the public utilities have at times been supporters of this tendency to enhance state power as a means of avoiding the increase in federal regulatory activities and in both local and national government ownership and operation

Some Conclusions

Government regulates and helps businesses whether they are classified as public utilities or not In regard to aids and restrictions both kinds of business have a close relationship and dependence upon government It cannot even be said that the government regulates some activities of public utilities which it does not regulate when the business is not so classified As shown the government has some influence upon the rates of the utilities but it also has influence upon the prices charged by other businesses The anti trust laws are influential on prices Laws permitting price fixing of branded products are very important in the determination of prices and many other examples of the influence of governmental action on the prices industry charges the consumer for its goods and services may be given Also governmental activities may decide whether a particular business enterprise may be undertaken Some enterprises are forbidden Protection of property and enforcement of contracts may prevent people from undertaking particular enterprises Governmental grant of patents and the protection of the patent holder may be determinant of the right of any other business men to enter that particular field of business This kind of governmental influence upon business is not limited to the accepted field of public utilities People do not have an absolute freedom to enter into business whether it be classed as a public utility or not In regard to the control over services industries held not to be affected with a public interest are restricted as well as the utilities There are pure food and drug laws laws on labeling laws on weights and measures and many others

which have some influence upon the standards of quality and quantity of services rendered by a business for its customers The financial practices of private businesses are also considerably influenced by government Securities are subject to considerable control by the Securities and Exchange Commission, blue sky laws and many corporation laws Many subsidized companies and the corporations which have borrowed money from the government are often controlled in many respects as to the services which they are required to render and the financial practices which they must observe Debtor businesses, even though not called public utilities are sometimes required to keep specified kinds of reports on their financing and these records are subject to governmental inspection

The conclusion is that the industries said to be affected with a public interest are subject merely to *different procedures* or *techniques* of governmental help and regulation than are those businesses not so classified Some writers have expressed this difference in other terms Some say that the regulation of public utilities is exercised directly on them by government and indirectly on other businesses not so characterized Still others have termed the difference to be that between positive and negative regulation the utilities being subjected to the former and private businesses to the latter It is becoming recognized however that public utilities are not subject to different kinds of governmental help and regulation than are other businesses

It therefore appears that the differences both as to grounds for classification and as to the kinds of regulation between businesses clothed with a public interest and those not so described are not great In other words the theses presented here is that the story of public utilities is the same as the story of the preceding chapters It is the story of governmental activities which aid and which coerce industry but which do so through special procedures It is also part of the record of how people think about the relations of government and business and of how governmental activities are moulded by the constant play of a variety of conflicting forces

CHAPTER 14

GOVERNMENT OWNS AND OPERATES BUSINESS

Many enterprises which had at one time been largely or completely private are today public If we go back far enough in history we find that highways were frequently built by private individuals who charged travelers a price for the privilege of using them Today the highway system in the United States is public enterprise almost to the exclusion of individuals or corporations The various units of government in the United States build our roads and charge for the service thus rendered in the form of taxation

Also for most of American history the American city dweller bought his water from a private corporation in much the same way that many people today buy gas or electricity Since the latter part of the last century however this business has been almost completely taken over by city governments only a small proportion of water for home and industrial use being supplied by water companies Cities maintain reservoirs frequently at very great distances as in the case of Los Angeles or New York City purify the water for consumption pipe it to the home or factory maintain pressure and charge a fee or tax for the service The same trend can be seen in supplying farmers with water for irrigation purposes Originally this water was provided by the individual farmer where he was fortunately enough situated or by groups of farmers where individual action was such a difficult engineering problem or so expensive an enterprise that collective action was necessary Government has entered this activity in the West by the erection of dams and by the production of electricity to be used as power for piping the water to the land to be irrigated Education may be given as another example of a very large public business

In many other enterprises the government owns and operates a much smaller percentage of the total business conducted On the whole it can be said that such fields are still dominated by private enterprise Power is generated and distributed by a great number of cities and the number of federal hydroelectric plants is rapidly on the increase It has been estimated that in 1938 federal state and municipal governments generated by water power 2 925 000 horsepower or 19 4% of total electric energy produced by both private and public hydroelectric plants in that year The federal government in the summer of 1939 had completed six hydro

electric plants and twelve others were under construction It is estimated that the ultimate generating capacity of these federal power developments will aggregate more than 6 100 000 kilowatts Not all of this power will be available for use in the home or the factory nor will all of it be distributed to consumers by federal state or municipal governments Some of the power will be used for pumping water for irrigation and for making of nitrates and phosphates and some of it will be sold to private power companies for distribution to the home or to the industrial consumer

In the business of the transmission of messages and packages the government has the post office and the parcel post but private enterprise still dominates the telephone telegraph and radio while the American Railway Express does a great deal of the package business There are some government owned and operated broadcasting businesses as can be illustrated by the municipal stations The transportation business is still very largely private enterprise but the government owns and runs some municipal transit lines some railroads such as the Panama Railroad the Alaska Railroad some steamship lines such as the Panama line between New York Panama and Haiti some shipbuilding yards and some inland water lines such as the barge lines in the Mississippi Valley operated by the government owned Inland Waterways Corporation

The government has entered the banking business in many different ways some of which are the savings business of the Post Office Department and the lending activities of Agricultural banks of the Reconstruction Finance Corporation and of the Export Import Bank In the insurance business the government insures bank deposits and employment In the real estate business the government owns and operates thousands of acres of land valuable for grazing reforestation parks mineral resources it builds and operates apartment houses and it furnishes capital at low rates for home building The government also has entered the business of marketing goods as shown by the Federal Surplus Commodities Corporation which is in the business of distributing surplus agricultural products and by the state owned and operated liquor stores

The Forces Which Cause Government Ownership and Operation

Government ownership is established in much the same way as is governmental regulation of business As has already been shown the latter occurs because some interests in our society want and support it The same is true of government ownership The government does not enter a field of business merely because some officer or group of officers wants such activity Back of the officer are the demands of farmers workers, business men and consumers

At the same time there is often opposition to the entrance of government into what is frequently viewed as the field of private business The result is a conflict of forces some supporting and some opposing the govern

ment s activities and this conflict is similar whether the government is regulating or operating businesses Business men are to be found on both sides of these conflicting groups All business men do not fight against all governmental enterprises any more than against all regulations of busi ness In both instances different business groups frequently work at cross purposes freely violating the oftheard assertion that business wants the government to keep out of business

One source of the pressures on the government is the attitudes of people Many believe that the government is incompetent Their thinking is often dominated by such slogans as inefficiency red tape politics and graft Other people have the opposite attitudes They believe that governmental enterprise is superior to private Their thinking is often dominated by other symbols such as private profit is evil business men are untrust worthy and government is a better protector of the general welfare than are private individuals Other sources of pressures are economic self interest war patriotism and tradition Because of these factors people may forget their symbols Certain governmental businesses may be favored because they are viewed as necessary to national defense or as economically beneficial and the symbols of graft and inefficiency forgot ten At other times the slogans for and against governmental enterprise may mould the pressures on government regardless of economic self interest or patriotism Also once a governmental business has been estab lished for a period of time and people have become accustomed to it they tend to take it for granted and not to think about it in the terms of their symbolisms and stereotypes Very often therefore support for and oppo sition to public businesses are based upon factors other than the evidence provided by actual experience

In 1904 under a Republican administration the United States entered into business in the Panama Canal Zone when it undertook to construct the canal The drive behind this enterprise was a mixture of patriotism national defense and the desire of business men for government assistance The armed forces in the name of national defense and patriotism strongly supported the enterprise and to the War Department was given control Business men on both the east and west coasts particularly the latter were vigorous in their demands that the canal be constructed They did not like the railway rates and desired cheaper means of transportation to get their goods to the market

In the Canal Zone the United States government is today the one big business man When the government acquired control it found itself the owner of a railroad capitalized at $7 000 000 and incorporated in New York The justification for keeping the corporation was its necessity to the construction of the canal but after completion of the canal in 1914 the government continued to own and operate the line which today is very much like any other railroad business There has been no drive to

get the government out of this enterprise Through the railroad the government has undertaken many other commercial activities too numerous to be listed in total here Their extensiveness however can be shown by selections The United States runs the following businesses shipping real estate telegraph telephone hotel bakery, ice coffee roasting ice cream, slaughtering dairy and many others

In 1924 under the presidency of Calvin Coolidge the United States went into the business of transporting freight on the inland waterways of the United States by means of the Inland Waterways Corporation Water transportation within the United States had been reduced very drastically in the latter half of the nineteenth century as a result of competition with the rapidly growing railroads The abnormal demand made upon the transportation system by the war however presented a definite need for greater facilities, and this turned attention to the rivers and canals

At the end of the war the government found itself in possession of a barge system and the question arose as to what disposition should be made of this property Military groups in the country were interested in keeping and developing these transportation facilities which would be useful in another war for more effective industrial mobilization of the nation Consequently they urged the government to conduct a barge business These motives were recognized by putting the newly created corporation under the control of the War Department In addition there was a considerable business demand that the government build up an inland waterways business Shippers agricultural and industrial throughout the Middle West approved of the cheap transportation rates and supported the corporation by giving it a great deal of business Cities along the waterways and their local chambers of commerce have always been strong supporters of government spending to improve the navigability of streams They also supported the government business which has involved the spending of millions of dollars in dredging and other activities in the development of water transportation This business interest in governmental enterprise has since been recognized by an Executive order transferring control of the Inland Waterways Corporation from the War Department to the Department of Commerce On the other hand the most serious opposition to the corporation has originated with the railroads which have suffered in some instances from the competition of the cheaper water rates

After the outbreak of the World War and during the period of American neutrality there was considerable agitation in the United States to put the government into the shipping business This pressure came largely from the exporting businesses and from the farmers The war expanded many times the European demand for American goods but American farmers and exporters faced great difficulties and great expense in getting

their materials across the water A shortage of ships together with the risks created by submarine warfare increased greatly the cost of shipment Privately owned shipping lines frequently made profits as high as 700% For these reasons primarily farmers and exporters came around to the position that the United States government should go into the business in order to assure them of shipping facilities and of lower costs Patriotic motives also played an important part Naval interests supported the proposals for government ownership on the grounds of national defense and the value of a merchant marine to act as a naval auxiliary in time of war

Shipowners and operators of course disapproved of the entrance of the government into their own business in this way The threat to the profits was felt keenly They found themselves in a very weak position however because the very reasons they had given since the Civil War in their struggle to get governmental subsidies were now used by the supporters of government ownership Both sides used the same arguments for opposite purposes Both contended that the United States needed a strong merchant marine in order to capture a larger foreign market for American business in order to strengthen the naval and military forces in time of war and in order to protect American exporters from foreign shipping lines

When the United States entered the war our ability to help the Allies was curtailed by the inadequacy of the American merchant marine It was too small to carry needed supplies and equipment to Europe and to transport troops The government therefore ordered the construction of vessels which it owned and for which it paid Those businesses closely associated with shipbuilding were very much in favor of this activity Their one concern was that the ships should be built in private shipyards at a profit to themselves and this they succeeded in accomplishing Many influential persons urged that the government construct the ships in its own yards but the business men who wanted the work were too powerful to allow this advice to prevail

When peace was declared only a small percentage of the ships for which the government had contracted had been built Less than one sixth had been delivered before the Armistice Construction had already been started on some but on others it had not even commenced If the war needs had been the only cause for government building and ownership of vessels the process of construction would have been terminated inasmuch as that necessity had ceased But of course that was not the only cause Shipbuilding interests wanted the work even if it meant government ownership Many other interests joined in bringing pressure on the government to prevent it from cancelling its contracts for construction and to induce it to increase the number of ships it owned for several years after the war These interests were composed of workers who wanted their jobs to

continue and of many business men who did not want their businesses stopped or diminished Among the latter were the private shipbuilders who were making lucrative profits under construction contracts the producers of materials who wanted the larger market for their goods the railroads which had the business of transporting the materials the realtors and property owners who made money from the increase in property values in the vicinity of shipbuilding yards and from the higher rents which the larger employment of the yards created and the merchants in the cities in the vicinity of the yards who were benefited by the spending of the employees of the shipbuilders More than one third of the government fleet therefore was begun after the war was over

Governmental subsidies and loans may also lead to government ownership and control because of the financial interest which the government acquires in the private business which it helps This control has resulted from the government s financial assistance of the merchant marine In fighting for this assistance therefore the shipping businesses have made possible the very government ownership and control which they so vigorously dislike Accordingly at the end of 1933 the shipping lines having mail contracts with the government except the United Fruit Line owed the government $112 514 000 on construction loans and unpaid balances of ship sales A fair estimate listed the total resources of these companies at $80 000 000 In other words the government investment was 1 39 times the stockholders interest in all assets and the government s fixed lien on certain of the vessels was equivalent to 60 per cent of the value of all contractor s vessels [1] Under the present subsidy system the United States government through the Maritime Commission has if anything increased its financial control The Commission provides for building vessels for private lines and has control over that construction The completed ship is then owned by the government but sold to the private steamship line at the estimated cost of construction abroad the additional cost for the actual construction in this country being a subsidy to the company The price charged the company is paid over a period of several years This debt of the shipping companies a result of their own pressure has had the effect of putting the government into the business whether the companies so intended or not It has been said by a competent authority that in 1938 *the Government is the real owner of the subsidized merchant fleet despite twenty years of effort to bolster and subsidize private enterprise*

The origins of the Federal government s hydroelectric power enterprises are pre New Deal The first bill providing for Boulder Dam on the Colorado River was introduced in Congress in 1922 The proposal was finally adopted by the Coolidge administration in 1928 For a short

[1] Paul Maxwell Zeis *American Shipping Policy* (Princeton University Press 1938) p 165
[2] *Ibid*

time the dam was named for Herbert Hoover in honor of his support of the project

Proposals for the Bonneville and Grand Coulee dams on the Columbia River were made during the twenties and both Coolidge and Hoover expressed approval of Grand Coulee They are New Deal however in the sense that this administration has started construction and is planning for operation

What is today the Tennessee Valley Authority has its origin in the Muscle Shoals development for military purposes during the World War The plant was built to produce nitrates for munitions After the war the dam was available for the production of electricity and there was considerable demand that it be so used This demand is shown by the fact that Congress twice passed legislation to provide for government operation of its own property once in the Coolidge administration and once in Hoover s Both Presidents however vetoed the bills thus giving evidence both of Republican support and of Republican opposition to government operation There seems on the other hand to have been little objection to government ownership of the plant Most of the pressure was against operation only Many interests wanted the government to lease its plant to a private operator and proposals to that end were made This program also was not adopted because of the opposition of those interests who wanted the government to operate its own property and the result was a stalemate for many years the government s property in the meanwhile standing idle The Tennessee Valley Authority which was shaped by the New Deal was merely a culmination of prior developments Two basic changes in governmental policy were made considerable expansion of the project and operation by the government as well as ownership

All of these projects do more than produce electric power They are what is known as multiple purpose projects All of them are designed to control floods which have often been destructive to property and life in the valleys down which the rivers flow and to improve the navigability of the streams An additional objective of the Western dams is the production of water and power for irrigation of arid lands the fertility of which is dependent upon such activities Boulder Dam also provides additional water supply for the city and district of Los Angeles T V A has the added functions of conservation and restoration of soil fertility resettlement of farmers whose lands are taken experimentation in the production of phosphates for fertilizers and production of nitrates for munitions in time of war The projects are often described as programs for the social and economic development of their respective regions of the country

The many activities of these governmental businesses are factors in their popularity with many interests Many business men farmers and consumers in the respective sections have supported the projects While

no doubt many people are influenced by their beliefs that government ownership and operation are on principle good and desirable and others approve it because they dislike private electric power companies there is also an economic drive Chambers of Commerce in each of the three sections of the country have often given support to their respective dams There has been approval of flood control which protects property and of the improvement of the navigability of the rivers which provides business for the transportation people and cheap rates for shippers Often has the argument been advanced that the cheap power of the government dams would attract industry and thus increase the general economic welfare of the whole region In the West farmers and business men such as realtors and bankers interested in land values have approved the irrigation activities In the Tennessee Valley many farmers formerly without electricity are now being served and many urban and industrial consumers are getting cheaper rates than they paid before Farmers have cooperated with the authority by forming groups for the purchase of power for experimentation with T V A fertilizer and for conservation efforts Many merchants in the cities have liked the influx of money which these projects have caused in the various sections

These projects have their opponents also but they have as yet been unable to make their demands entirely effective While no doubt many people throughout the country would express opposition on the grounds of their beliefs that government should not compete with private business and that government is incompetent to manage a power business, the articulate overt and organized opponents have been for the most part the competing private power companies While the private utilities of Southern California tried to prevent the construction of Boulder Dam they were pleased with the government s plan to sell power to them for distribution to consumers Although they argued that the additional power of Boulder was not needed they bought all they could get and complained because the Department of Interior which administers the Boulder power business did not allot them more The Department had no difficulty contracting for the sale of all the potential power of the dam before it was completed even though no rates were specified In fact, there was a market for much more of it the difficulty being to keep all purchasers satisfied with what was allowed them Some states, other than California in the Colorado Valley were concerned that they would not get large enough shares of the power and water but their opposition was eliminated by compromises whereby they became satisfied that their interests were protected

The opposition to Bonneville and Grand Coulee led by the private utilities of the Northwest, failed to prevent the projects The biggest controversy in the Northwest has been over the sale of the power the utilities and other interests demanding that the government sell them the power rather than distribute it directly to consumers

The private utilities which compete with T V A and various national business organizations like the United States Chamber of Commerce and the National Association of Manufacturers have been the primary and most powerful opponents of that governmental enterprise Also having failed to prevent the government s entrance into that power business they have since been active in trying to restrict the activities of the Authority They have maintained a persistent attack on T V A and have no doubt mustered the support of many people who have an inclination to attitudes antagonistic to government ownership and operation

It is almost axiomatic in government that where there is no demand for governmental enterprise or where the desire for it is weaker than the opposition the government will not undertake any business In this country most people today are satisfied with private ownership of radio broadcasting railroads telephone and telegraph Consequently while there has been some advocacy of government ownership and operation in these businesses it has not been established

Proposals for other federal hydroelectric power projects similar to T V A have been made but not adopted due almost entirely to the fact that opposition in the proposed sections has been stronger than support One such a proposed development would be the Connecticut River Valley which has been many times badly affected by floods The New England states have combined to prevent federal power development by the construction of dams to prevent floods thus providing a potential source of electricity The dams are wanted and the protection from floods is demanded but to prevent power developments the states have insisted that the national government give them the money and control of the dams A similar proposal has been made for the construction of three dams on the Delaware River In July 1939 army engineers held hearings to get the reactions of the interests in that section Overwhelming opposition was expressed by the anthracite coal industry, the national soft coal organization chambers of commerce the Interstate Commission on the Delaware River Basin and private power companies Minority business support for the project was given by the Chamber of Commerce of Bushkill Falls Pennsylvania and the Electric Power Company of New Jersey As already emphasized some businesses do want government ownership and operation of some enterprises

Governmental Experience in the Management of a Business

There is no conclusive evidence that government is any less or more capable in the management of a business than are private individuals In the final analysis the experience of the government is dependent upon the pressures upon its activities and not upon inherent abilities or inabilities In that sense the government s problems are similar to those of private corporations Both are influenced by their environments by the

attitudes of people toward them and by the necessity to satisfy their customers They must meet the pressures of their workers their consumers and their competitors Neither has inevitably any more or less inefficiency politics red tape or graft than the other Each is successful only in the eyes of the people who are judging it and whose attitudes or satisfaction with its services or goods make them think it is successful

The most important factor in the environment in which the government must operate its businesses is the organized overt pressure that is made upon the government and to which it responds The demands which people make upon the government differ in the cases of governmental monopoly and of governmental competition with private businesses Therefore in order to describe the experience of the government the two kinds of governmental enterprise must be treated separately

(a) Non Competitive Businesses

No doubt there is an unorganized and amorphous objection to these businesses in principle That is those people who believe that the government cannot operate a business would say that they object to the monopolistic enterprises as well as to the competitive ones On the other hand such vague reactions seem not to be significant as restrictions on the government s activities Governmental services and goods are purchased by people who need and want them just as if the businesses were conducted by private enterprise

This is not to say however that there is no pressure brought to bear on the government by such purchasers On the contrary there is usually a very strong demand for more and better services and for lower costs Far from wanting to see the business curtailed or destroyed the customers businessmen as well as others demand that it expand In their reactions to this kind of governmental business they do not set up profit as a standard of business performance On the contrary they demand such low prices that they may, and sometimes do, produce deficits for the government s business The fact that this pressure of consumers does often produce a loss to the government is ignored by them except at such times as they are fighting against another governmental business which they happen not to want On those occasions they do point to governmental business deficits for which they themselves are partly responsible as examples of governmental inefficiency Some opponents of government electric enterprises for example have used the stock argument of government inefficiency in business as shown by the operating deficits of the post office

When governmental monopolies are charged with being inefficient by persons who are discontented with the service rendered there is no effort to abolish or hinder the business On the contrary the objective is to strengthen government ownership and operation by trying to get the

government to provide more and better that is more satisfactory service When one complains that a letter was delivered in three days instead of two that a package of the parcel post was torn or crushed or that a letter was lost he does not mean that the government should get out of the mail business He wants the post office to do what he thinks is better business by delivering mail more quickly by taking better care of packages or by preventing the loss of mail On the other hand because of attitudes antagonistic to governmental enterprises which many people possess unsatisfactory services are often explained on the ground of governmental inefficiency At the same time the failure of private companies to satisfy customers may not be thought to be due to the same causes

Municipal water works repeatedly face the demands of consumers including industries within the city for lower water rates for greater water pressure and frequently for the development of more water resources During the depression there were some instances of industry demanding lower rates even though the water business was running at a deficit The real estate business has been particularly vigorous in making these demands Municipal electric companies where they constitute the sole or predominant source of electric power in the city must frequently face similar pressure Quite recently some of the contractors for electric power from the Boulder Dam started a campaign to get the United States government to reduce the price of that power In the Panama Canal Zone governmental businesses have had occasionally to face demands for improved services such for example as for fresher foods or for newer and better coaches on the railroad line In the business of building and maintaining highways the automobile owners automobile associations trucking interests and the manufacturers of automobiles and associated industries want more bigger and better highways but fight to keep down the costs in the form of tolls and of automobile and fuel taxes The United States Post Office has a monopoly of the business of carrying mail and most people use this service Most users approve of practices which produce a quicker service such as the air mail, even though these practices may not meet the costs People do not demand that the government make a postage charge high enough to meet expenses let alone a profit Farmers want the mail delivered to their homes and support this service even if the amount of business done is not great enough at the low postal rate to meet the costs of rural delivery Advertising newspaper and magazine businesses do not point out that the amount they paid for mail service is so low that it produces a loss on that service

(b) Competitive Businesses

When the government is operating a business in competition with private businesses its problems are much more difficult because there is a

more severe conflict of organized and overt pressure and demands In the first place there is support from groups made up of those who are customers whose attitudes are in favor of governmental enterprise or who believe that the business is necessary for some other desired objective such a national defense Usually business men may be found in all of these groups It is these forces which keep the governmental business in existence and which prevent its opponents from abolishing it Their efforts are similar to the pressures on the monopolistic businesses The demands are for more satisfactory services and for lower costs

On the other hand the competitive governmental businesses must face what the evidence shows to be very strong opposition made up of the competing businesses and those people who believe that the government cannot manage a business as well as can private individuals Usually the essence of the organized and overt opposition which is often effective and always important is the combination of competitors The demands are just the opposite of those made upon the non competitive businesses Efforts are made to decrease or, if possible to abolish the government s business and to raise the rates for its goods and services The latter is a means to the accomplishment of the former because higher prices may make the customers and supporters of the enterprise discontented with it stop doing business with it and withdraw support

In the accomplishment of their objectives the opponents of the business often charge that the government is guilty of unfair competition The unfairness rests upon the grounds that the government is too strong a competitor for the private business because the government business need not make a profit while the private business must do so if it is to remain in operation The tendency of the charge is therefore, to raise the prices charged by the government for its goods and services with the possible results mentioned above Whereas governmental monopoly is not viewed as unfair if it shows a loss many people believe a governmental competitive business is unfair unless it breaks even or shows a profit It is here that the great controversy over accounting methods arises Whether any business makes a profit depends upon what it estimates its costs to be A particular income will show a profit or a loss depending upon the estimate of costs The contention is, therefore that the governmental business does not include enough items in its costs with the result that it is charging such a low price that it is really making a loss upon any accurate estimate of costs which loss must be made up by the taxpayers On the other hand, whether the competition is unfair or not depends upon the group which is doing the judging Whereas a competitor might think that governmental prices are unfair, a customer and it might be a business man or a corporation might not agree Desirous of buying at as low a price as possible the latter might think the government is fair if it gives him a satisfactory price Nevertheless the generalization that government

should not compete with private business has become a firmly fixed slogan which governs the thinking of many people In a sense all competition is thought to be unfair

In the struggle against a governmental business which competes other charges are made The government is said to be inefficient and unable to manage a business as well as private individuals because it is full of politics red tape and graft But not always is the charge one of in efficiency Sometimes governmental enterprise is said to be too efficient Thus some private steamship companies complained that the government owned and operated Panama Steamship Company was too aggressively soliciting freight traffic and took away from them much of the potential freight business of foreign ports

No doubt these charges against governmental enterprises serve to develop some opposition to them The words government competition unfair competition inefficiency graft politics and red tape are bad terms People do not like them and are conditioned to react unfavorably when they are used On the other hand it must be assumed that the people who make these charges are always doing so insincerely On the contrary they often think in these terms use them sincerely and believe what they say is true Because of these conflicts which the government must try to resolve its non competitive businesses are more likely to be judged successful than the competitive ones because they are accepted by more people The latter has more vigorous and widespread opposition and there are therefore more people to judge them as being unsuccessful

The record of the Panama Steamship Company shows very well the pressure of opponents made up largely of private competing lines the Shipping Board and the American Steamship Owners Association to reduce the amount of business done by the government s line During the Coolidge administration the company decided to replace some of its obsolete ships with new ones to be paid for by its own funds but there was opposition to the increased efficiency and competitive power the new equipment would give to the line and President Coolidge prevented the replacement Orders were also issued to the line to reduce its services It was forbidden to carry coal for its parent company the Panama Railroad and the business was given to a private line Thus the government was forced to bear the additional cost The shipping line was also taken out of the Caribbean and South American trade and in 1933 was serving only the Canal Zone and Port au Prince in Haiti thus leaving its other business to the private lines

While the government was restricting its own corporation private competing lines were being assisted The Panama Line s annual mail contract of $48 000, for example was taken away from it and given to a private line Also under the Jones White Act the Grace Line was receiving in 1933 annual mail contracts of $2 454 474 and a construction loan of

$14 739 806 the United Fruit Company s mail contracts were $1,483 112 and its construction loan was $15 412 500 and the Columbian Line received $524 710 in mail contracts and $3 614 500 for construction

Shippers and other business interests were not always pleased with this reduction in the services which the government business was permitted to render for them American Consuls in the Caribbean and South American ports whose duty it is to protect the interests of American business men and exporters in the foreign markets frequently reported a loss of business and recommended that the Panama Line s services be extended The United States Department of Commerce which is the government s spokesman and salesman for American business also has frequently urged an increase in the company s activities in the interest of American exporting businesses In more recent times support for the Line has increased considerably and some of its obsolete ships have been replaced by new and modern ones

Sometimes the government is prevented from operating a business which it owns This is shown very well in the experience of the Shipping Board during the twenties The United States was faced with the question of what to do with the vessels which it had built and which it owned Private shipping and other interests were vigorously opposed to the suggested policy of governmental operation of its own property, and there was little support for governmental operation For the most part therefore these ships lay in port gradually deteriorating or were leased to private lines for their use Only a relatively small number was operated by the government itself The form of lease used gave extremely good terms to the private lines virtually guaranteeing them from any loss in their operation of the vessels Under these leases the United States government lost millions of dollars

So long however as the government owned the vessels private lines and other opponents were afraid that the time might come when they would be unable to prevent operation Accordingly there was strong pressure to get the government to sell its ships and other equipment to private interests at very low prices One argument frequently advanced in favor of the sale was the inefficiency and incompetence of the government and in support of this argument they pointed out the enormous losses the government has sustained under its operating contracts with private operators They ignored of course the fact that these losses were incurred by private businesses and not by the government which in fact merely owned the ships and did not operate them The pressure was very successful however and the government sold at great loss to itself many of these vessels to private lines For example in 1924 1925 1926 the Dollar Line bought seventeen vessels from the government for $13 975 000—vessels which had cost the government $92 549 800 That these ships had a much higher value is shown by the fact that insurance com

panies were insuring them at considerably more than the company had paid for them in 1933—that is after they had been used for many years and had greatly depreciated in value Other ships which had cost more than $200 per dead weight ton to build were sold at less than one tenth of that amount Some were sold for scrap at prices as low as $8 a ton Other equipment owned by the government was sold by the Shipping Board to private purchasers at such low prices that the buyers could resell it at one hundred per cent profit without even moving it from the warehouses in which it was stored So interested were the shipowners and related interests in getting the government out of the business that they ignored the financial loss which their efforts created for the government In many instances the government s loss was their immediate gain In fact the Dollar Line was so pleased with the deal which Stanley Dollar made in his purchase of government owned ships that it gave him a com mission of $635 493 75 for buying them so cheaply

Pressure to force higher rates and charges of improper accounting are illustrated in the experience of the Inland Waterways Corporation and the Tennessee Valley Authority The so called hidden costs which it has been alleged that the Inland Waterways Corporation does not include in its rate structure and which if included would entail higher rates are government expenditures for improvement and maintenance of waterways for navigation interest on total capital investment corporation income taxes (it does pay real estate taxes), free mail service (the government franking privilege) rent on the main office in Washington and low tele phone and telegraph rates given to governmental agencies Of these factors only the first one would have much effect in forcing the cor poration to raise its rates and upon this item there is no agreement among the authorities Any attempt to assess the governmental corpora tion its share of total expenditures on navigable streams would be little more than a guess and it would be very difficult if not impossible to say that anyone s guess was wrong Privately owned and operated barge lines have the benefit of the same expenditures and improvements made by the government but do not include such items in their cost estimates

The most important hidden costs of the T V A s power business are governmental expenditures for construction and maintenance of the Authority s various plants and dams In trying to assess these items to the rate base the multiple purposes and activities of the T V A create extreme difficulties for the accounting system The fact that the Authority spends money to improve navigation to prevent floods to conserve and rebuild the soil and to produce power make it well nigh impossible to create one correct standard upon which the expenditures are to be divided among these various activities Should the fact that they are all parts of a plan of regional development mean that none of the expenditures should figure in the rate base for the Authority s power? Or should this same

fact mean that all the costs be assessed against the production of elec tricity because all the expenditures serve that activity? This leads to other questions impossible of definitive answers Is the power business of T V.A its real purpose and objective and the other activities merely incidental? Or is the production of power merely a resultant of, and inci dental to the other functions? Or are all these activities to be given equal weight? There is no one correct answer to these questions the answers being subject to one s opinions Therefore, there is no one correct accounting system

Some Conclusions

Whether the government enters into a business and what it does in the management of a business are determined by that combination of forces which moulds and directs all governmental activities The conduct of what is called business is in fact *only one of the ways* in which the government does things for and against people including business men It is therefore like the governmental activities which have been de scribed in previous chapters as aids and regulations of private business There are the same conflicts of forces, the same demands support and opposition and the same attitudes A governmental business may amount to a governmental aid and even subsidy to many people and many private businesses and therefore be approved by the recipients At the same time it may amount to a restriction or regulation of other people and of other private businesses and therefore be disapproved by them It seems to be quite common to find people disapproving of governmental ownership and operation in principle but supporting particular enter prises

If experience is any guide the number of governmental businesses will continue to grow because the factors leading to governmental ownership and operation in the past are to be seen at work At what rate this increase will occur is not known It is of little value to say that these changes should come about slowly No one knows just how fast is too fast It seems clear that to those who want or need the establishment of a particular governmental business it may come too slowly whereas to those who do not want it and particularly to those who fear it it always comes too fast No objective tests of moderation have ever been set up

Experience would also indicate that if the government should enter a new business its difficulties would tend to increase in so far as the business was competing with private individuals The acceptance of the business as successful would tend to increase with its monopolistic character For example in the business of radio broadcasting the government could take over all private broadcasting stations and thus create a monopoly or it could set up its own national chain in competition with the private broadcasters Should it do the latter experience would seem to indicate

that the private broadcasters would wage war on the government chain It would face the very probable assignment of poor hours and bad wave lengths which would prevent very effective competition with private business If all broadcasting stations were owned and operated by the government efforts would then be made by many groups to get more and cheaper broadcasting opportunities

PART V

Money and Banking

CHAPTER 15

MONEY

Necessity for Money in a Specialized Society

Specialized production is limited by the extent of the market and one of the most important factors affecting the extent of the market is the presence or absence of an efficient medium of exchange Very early in the history of even extremely primitive societies it was recognized that if certain individuals specialized in the production of one or a few commodities and exchanged their surpluses of these commodities for the surpluses of other specialized producers that all would benefit The earliest exchanges were usually barter transactions for example a direct exchange of so much wheat for so much beef Barter transactions have continued through the ages but always in proportionately lessening amounts Even in the United States today a boy may swap a knife for a baseball and farmers often exchange their eggs and butter at the country store for sugar and coffee But actually such transactions are not examples of real barter In the transaction at the country store the farmer s eggs and butter are given a monetary value and he receives its equivalent in sugar and coffee No actual money is used in the exchange, but it serves to provide the basis for the exchange

As the amount of specialized production and therefore the need for the exchange of goods increased, the inefficiencies of the barter system became more apparent It was not always easy for a person wishing to exchange commodity A for commodity B to find some one who wished to exchange B for A and especially was it difficult to find some one who wished to exchange the goods in the exact amounts desired by the producer of commodity A Suppose for example that commodity A was a horse which it was desired to exchange for shoes The shoemaker would probably not want a horse but if he did the owner of the horse would probably not want a horse s worth of shoes In our present complex economic society the impossibility of direct barter is quite apparent Suppose that on Saturday night a worker in a textile factory were paid so many yards of cotton cloth for his week's services Then think of the cumbrousness if not the impossibility of his exchanging this cloth for the many different goods he desired Even more impossible would it be for a firm like the Baldwin Locomotive Company to pay its obligations with the firm's product

Because of these difficulties there could be but limited development of trade and therefore of specialized production under a direct barter economy It soon became apparent that trade carried on through a process of indirect barter that is through an intermediary an unspecialized medium of exchange would to a large extent obviate the cumbrousness and inadequacy of direct barter This intermediary or money assumed varied forms among different peoples Sometimes it was salt again it was tobacco or cattle or beads or the precious metals The commodity chosen was always one which was almost universally wanted by the people concerned For this reason there was little doubt that if a specialized producer exchanged his commodities for salt tobacco or any other generally recognized medium of exchange he could always secure the commodities he desired in exchange for the recognized money

Gradually the precious metals and especially gold took precedence over all other commodities as the generally recognized medium of exchange to such an extent that in popular thought the word gold became practically synonymous with money Thus barter economy was superseded by a money economy which in the countries most advanced economically became a gold economy However the serious maladjustments brought about by the World War of 1914 1918 and by the great depression beginning in 1929 and the extreme economic nationalism of recent years emphasized in the highest degree in the fascist countries have caused practically all countries to leave or at least to modify greatly the gold monetary standard In fact, during the worst of the depression in the United States many people were again reduced to barter and in international trade Germany especially has resorted to the direct exchange of goods for goods But it must be emphasized that for whatever reason a generally accepted monetary system weakens or breaks down a deleterious effect on trade results which injures productive efficiency and thus lowers the standard of living

The Functions of Money

The simple definition of money that it is anything generally acceptable in exchange expresses its first function—to serve as a medium of exchange This function has been discussed in the preceding section where the reasons for the shift from a barter to a money economy were explained A second function of money is to serve as a standard of value A value in monetary terms is usually attached even to those goods whose owners have no idea of selling them We say that Mr Ford is worth so many hundred million dollars when actually at a particular time he may have relatively few dollars in his possession The statement of course means that to the Ford plant a valuation in terms of dollars has been attached The wealth of the United States is said to be so many hundred billion dollars a sum many times in excess of the number of dollars in circulation

in the country Money is simply a measuring rod a standard of value in cases like these

A third function of money is to serve as a store of value If one wishes to store up goods for future consumption for future investment or to leave his heirs it is not necessary to store up food clothing and other like commodities Money can be saved either under the mattress at home or more usually in a financial institution like a bank or insurance com pany and used later as the owner desires

A final function of money is to serve as a standard of deferred pay ments As economic society has developed an increasingly large pro portion of business takes the form of credit transactions that is one party to the transaction defers meeting his obligations to pay until some future date and practically all such obligations are payable in the standard money of the country concerned Without a reasonably safe money such credit transactions would be greatly lessened and the eco nomic activities of the country seriously curtailed

Qualities of a Good Money

It has been seen that the precious metals especially gold gradually superseded other commodities as the medium generally acceptable in exchange The reason for this was that gold was generally held to possess the qualities of a good money to a greater degree than any other com modity Among these qualities are desirability scarcity durability stability portability divisibility cognizability

The monetary commodity being desirable in itself tends to make people more willing to accept it especially in the period when a monetary system is being developed The use of salt beads cattle and tobacco as money in early economies shows the importance of this quality in the choice of the monetary commodity The almost universal desire for ornamentation gave the precious metals the quality of desirability To serve as an efficient money a commodity should be relatively scarce in comparison with most of the goods for which it is to be exchanged This scarcity tends to make a relatively small amount of the monetary com modity have a high value in relation to other commodities and thus prevents the money from becoming too bulky On the other hand the monetary commodity should not be excessively scarce as platinum for example Excessive scarcity prevents a sufficient supply for the monetary work to be done and furthermore tends to make an extremely small unit have too high a value to serve as an efficient money

It is very desirable that the commodity serving as money should be durable Cattle tobacco and the like are perishable and cannot serve so well as the monetary medium as can durable commodities like the precious metals Gold and silver do not spoil and handling wears them out but little Since previous years output of these metals remains largely intact

the output of succeeding years, especially of gold is but a small per centage of the total supply This gives stability of value to gold money to a greater degree than to practically any other commodity that could be used Fluctuating crops of tobacco cause the value of tobacco to vary widely from year to year The relative ease of producing beads makes it possible to increase their supply rapidly and therefore to change their value in relation to other commodities rapidly If the only function of money was to serve as a medium of exchange a rapid change in its value would not have such serious consequences But increasingly important is the function of money as a standard of deferred payments More than nine tenths of the business of the United States is carried on through credit transactions As will be shown in more detail later, a rapidly changing value of money creates serious injustices between the parties to these transactions While gold is by no means perfectly stable in value over a period of years nevertheless it has greater stability than any monetary standard yet tried on a large scale

Ease in carriage or portability, is also desirable in a good money Con sider the difficulties in taking a tour through the United States if tobacco constituted our supply of money Because of their high value in small bulk gold and silver have the quality of portability to a greater extent than most other commodities But even these are too heavy and bulky to serve as a satisfactory pocket money and paper substitutes and later bank deposits have been introduced to serve in their place

Business transactions require monetary units of differing values For example it would be a great inconvenience if there were no unit with a value of less than ten dollars It can be seen that cattle did not make a good monetary medium for a person might want to purchase something that had an exchange value equal to one tenth of a cow Within limits gold and silver are divisible into perfectly homogeneous units so that there can be different sized units with differing values It has been found however, that a gold piece of a value less than five dollars is too small to serve as a convenient money, and substitutes of silver and baser metals are used for subsidiary coins

An ideal money should be easily recognizable If the money offered must be tested as to quality and quantity exchange transactions are hampered The precious metals are rather easily recognized but even in their case it soon became desirable for governments to put their stamps on money so that there would be no question concerning its value

Government Coinage and Control of the Monetary System

Because of the great importance of money to the economic life of a country every government today controls the issuance of money Each government decides what shall serve as the monetary standard it deter mines how much of the commodity shall be contained in the standard

unit it has a monopoly on the coining and printing of money and it regulates in one fashion or another the issuance of notes and the extension of credit by the financial institutions of the country If private individuals and concerns were permitted to issue money as they saw fit there would be so many different types of money that people would hesitate to accept any Particularly would credit transactions be hampered for creditors would not know in what sorts of money they would be paid and what the value of a particular money would be at a later date These difficulties have at times arisen in connection with governmental issues as when monarchs of the Middle Ages clipped or otherwise debased the gold coinage or as in the cases where modern governments have reduced the gold content of the monetary unit or have issued larger sums of paper money than could be redeemed in gold But despite such occurrences there is no question that the general confidence is much greater in money issued by government than it would be in private issues and without general confidence in it no monetary system can perform its functions well

Until the depression years of the 1930s all the leading industrial nations of the world were operating on a gold monetary standard Each government establishing the gold standard decided how much gold should be contained in the standard unit For example until 1934 the United States government had established the gold dollar containing 23 22 grains of pure gold, or 25 8 grains of gold nine tenths fine as the standard unit In 1934 this content was reduced by a little more than 40 per cent and the dollar now contains 13 71 grains of pure gold or 15 23 grains of gold nine tenths fine Other countries have also had their standard gold units as the pound sterling in England and the franc in France In the countries operating on a full gold standard while the gold was coined by the government nevertheless any individual possessing gold could take it to the mint and have it coined Under this free and unlimited coinage of gold there could be no variation between the value of a gold dollar for example and the value of its equivalent weight of gold bullion If for any reason the gold dollar should have temporarily had greater value than 25 8 grains of gold nine tenths fine gold bullion would have been taken to the mint for coinage, under reverse conditions the bullion would have been sold for industrial uses and gold coins would have been melted into bullion

The governments also decide on the amount of silver and other metals to be used for the subsidiary coinage or change The purpose is to coin just enough for the work to be done by these small units and governments buy these metals in only limited amounts In other words where the gold standard exists there is no free and unlimited coinage of silver nickel or copper

The engraving and printing of paper money is also a government

monopoly Governments issue various types of paper money they determine the amounts of such issues and the governments engrave and print them Various private financial institutions also at times are given note issue privileges Such issues are usually closely regulated by governmental legislation and in the United States bank notes are supplied by the United States Bureau of Engraving and Printing just as is the paper money issued by the government

In a number of countries including the United States bank deposits constitute a very large percentage of the money supply Usually this bank deposit currency is closely regulated by governments so that the depositor can be reasonably assured of the safety of this type of his money

The Monetary Standard and Standard Money

The monetary standard of any country is that something which fixes the value of the standard monetary unit For example in gold standard countries it is the lump of gold having the exact weight and fineness which governmental legislation has designated for the standard monetary unit In the United States prior to 1933 the monetary standard was 25 8 grains of gold nine tenths fine and the gold dollar had the same value as this lump of gold Where the monetary standard and the standard money are of the same commodity it may seem of little consequence to differentiate between them But more and more there is discussion of instituting a planned or managed currency for the purpose of stabilizing prices The usual idea back of these proposals is that the monetary unit shall have the same purchasing power in respect to a selected list of commodities over a period of years If such a multiple commodity system should be adopted it is quite apparent that the monetary standard for fixing the value of the standard money would be the selected list of commodities The standard money would almost of necessity be a paper unit and managing the currency would take the form of varying the amount of paper units so that each would have an unvarying purchasing power in relation to the selected list of commodities

Standard money is the money whose value is independent of any other types of money in circulation in the country and which fixes the value of all the other types of money in circulation In the United States prior to 1933 there was no doubt that the gold dollar was our standard money Its value was fixed independently of all other types of dollars and its value fixed that of the other kinds of money in circulation This maintenance of a uniform value among all the types of money in circulation in a country is the principal function of the standard money This is achieved by establishing free convertibility of all other monies into the standard money Under the gold standard for example all other monies—silver and subsidiary coins paper of various types bank deposits—are freely convertible into gold and thereby the purchasing power of all

types is kept uniform A secondary function of standard money is to serve as the money of international trade The topic of international payments will be discussed in a later chapter

There have been various types of monetary systems in operation in different countries at different times Some of the more important of these will be discussed

The Monometallic Standard

When a country s monetary standard is composed of one metal it is said to be a monometallic standard Until the early 1930s all leading countries were on such a standard the single metal being gold China however although also having a monometallic standard used silver in stead of gold as its monetary standard

The gold standard exists when a country by law establishes a certain weight of gold as its standard money In the United States this weight was formerly 23 22 grains of pure gold and in England it was 113 grains By legal enactment a dollar was 23 22 grains of gold and a pound was 113 grains As has been explained earlier free and unlimited coinage of gold and free melting of gold coins made impossible any variation in the value of the standard coin from that of its equivalent weight of gold bullion The United States government prior to 1933 stood ready to buy all gold at $20 67 an ounce and equally it permitted anyone to melt gold coins into bullion Necessarily therefore the price of gold at the mint and for non monetary uses was the same—$20 67 an ounce In 1934 the gold content of the dollar was reduced to 13 71 grains of pure gold which was another way of saying that the price of gold was set at $35 an ounce The changes made in our monetary standard at that time will be discussed later

Standard gold money is made full legal tender that is it is a money which creditors must accept in payment of obligations due them Under the gold standard all other monies are kept at par with gold by making them convertible into gold If a country is on a full gold standard any holder of other types of money—paper bank deposits or what not—can always have them converted into gold dollar for dollar In this way the purchasing power of the various types of money cannot differ Due to this privilege of convertibility government notes bank notes or bank deposits amounting to one hundred dollars have the same value as one hundred dollars in gold money and therefore prior to 1933 had the same value as one hundred times 23 22 grains of fine gold

The full gold standard also implies free movement of gold into and out of a country in payment of international balances Debtors must have free access to gold to meet their foreign obligations and creditors must be allowed to receive gold in payment of their foreign claims

The silver standard is based on the same principles as those just de

scribed in connection with the gold standard Under it there is free and unlimited coinage of silver silver coins are made full legal tender all other forms of money are freely convertible into silver and silver is free to come into and to leave the country in payment of international balances But during the last century the wide fluctuations in the value of silver bullion made it less satisfactory as the monetary metal, and all the important industrial nations used gold instead

The advantages of the adoption of the gold standard by the leading industrial and commercial countries were the stabilization of the foreign exchanges greater stabilization of the internal price levels As will be shown in detail in a later chapter the par rate of exchange between the currencies of two gold standard countries say formerly between the dollar and the pound is determined by the relative gold contents of the monetary units The market rate of exchange between such currencies can fluctuate only within narrow limits for if one currency falls much below the par rate gold can be shipped to the other country The limit of the divergence from parity is thus set by the cost of transferring gold between countries This stability in international exchange is favorable to business transactions between countries, and thus is a definite benefit of the gold standard

The gold standard had the tendency to stabilize internal prices because the amount of gold increased but slowly but over a considerable period of years its supply increased at about the same ratio as business activity This in itself tended to make prices over that period relatively stable Furthermore it was more profitable to increase the production of gold during falling prices and to decrease its production during rising prices It must be remembered that the price of gold is legally fixed in gold standard countries For many years in the United States its price was $20 67 an ounce During a period of falling prices the cost of gold production fell its price remained the same there was greater profit in gold mining and there was thus a tendency for a greater output This greater output tended to cause the value of gold to fall or in other words, tended to cause prices to rise Conversely during periods of rising prices gold mining was less profitable and the output of gold tended to diminish This tended to give gold a greater value, or to cause the price rise to be checked

The free flow of gold between gold standard countries also checked a great rise or fall of prices in one country alone If the price level of one country say the United States fell more rapidly than the price level in another country say England the United States was a good country in which to buy and England was a good country to which to sell This tended to cause a flow of gold from England to the United States and to bring greater equality in the price levels of the two countries

But beginning with the World War of 1914 1918 there have been con

tinuing economic maladjustments which except for a brief period in the 1920s have prevented the so called automatic working of the gold standard Due to their heavy military expenditures the belligerent European nations during 1914 1918 found it impossible to redeem in gold their various obligations to pay They went off the gold standard During these years much of Europe s gold made its way to the United States in payment for American supplies Readjustment after the war was slow and it was not until the middle twenties that most of the European countries returned to gold and now it was in the form of the gold bullion standard rather than of the pre war gold coin standard

The gold bullion standard is usually introduced to conserve the supply of a country s gold It was for this reason for example that England was on such a standard from 1925 until 1931 The obligation of the Bank of England to redeem its notes in gold was suspended but holders of bank and government notes were given the right to exchange them for bars of gold containing not less than 400 ounces of pure gold and the Bank was allowed to sell gold bars of this weight This meant that the pound equivalent of over $8 000 had to be paid for the minimum bar of gold This naturally meant that few people exchanged notes for gold Gold of course was not in circulation as money and the chief reason for securing it was to meet foreign obligations Even this substitute for the old gold standard broke down in all the European countries during the depression years of the 1930s and all found themselves actually on inconvertible paper standards

The Bimetallic Standard

Until the depression years of the 1930s it had been generally assumed that bimetallism had become a dead issue in the United States after the defeat of William Jennings Bryan in the presidential election of 1896 But the extremely low prices of the depression years revived interest in many economic and financial nostrums and there was a movement to place our monetary system on a bimetallic standard This did not succeed, but as will be shown later the silver bloc was able to put through an enlarged silver purchasing program by the government

Under bimetallism the monetary standard consists of both gold and silver The monetary unit say the dollar represents either so many grains of gold or of silver the ratio between the two metals being fixed by law For example Mr Bryan's proposal was that the United States should establish a mint ratio of 16 to 1 between silver and gold Under this ratio the dollar would supposedly have been equal in value to either 23 22 grains of fine gold or 371 5 grains of silver Both metals would have free and unlimited coinage would be full legal tender would be free to meet all international obligations In addition all other monies would be freely convertible into either gold or silver

Supporters of bimetallism have urged that there would be greater stability of prices under this double monetary standard than under the single gold standard This argument is based on the so called compensatory action of the double standard Under this principle it is held that any change in the market value of one metal would be counter balanced by a change in the use of this metal for coinage If for example during a certain period silver production should expand more rapidly than that of gold it is contended that the silver would be coined and that gold would go to the market rather than to the mint This would continue until the market ratio between the two metals was again equal to the mint ratio

As a matter of fact experience with the bimetallic standard has shown that the so called principle of Gresham s Law operates rather than the compensatory principle In popular form Gresham s Law is that bad money drives out good money or more carefully stated it is that money which for any reason is inferior in exchange or substance value shows greater tenacity in circulation than money which is deemed to be superior A moment s reflection will show that if any of us has doubts about any of his money he will spend that earlier than the money of which he is more certain Accordingly if the mint ratio between silver and gold should be established at 16 to 1, while on the market the bullion ratio was 20 to 1 possessors of silver would take it to the mint and holders of gold would dispose of it as bullion on the commercial market And it has never worked out that the compensatory principle has brought the mint and market ratios to a parity What has happened has been that the metal overvalued at the mint has driven the other metal out of monetary use and to all intents and purposes the country has gone on a monometallic standard with the overvalued metal serving as the standard This tendency is accentuated if the other important countries are on the gold standard Such countries would accept only gold in payment of international balances but they would be perfectly free to pay silver to the bimetallic country

Inconvertible Paper Standard

Because of the instability of prices under any monetary standard which has been established some authorities have suggested that the monetary standard should be based on inconvertible paper This is sometimes called fiat money since its acceptability would be based on a government decree saying ‘let it be made money The argument is that there can be no stability in a monetary system based on the vagaries of the output of gold mines At times there will be a large output of gold lessening the value of the monetary metal and causing a rapid rise in prices Again, gold production will be small its value will increase and prices will fall

On the other hand the governmental authorities can decide how much inconvertible paper money should be in circulation at a particular time and can issue it in proper amounts to maintain the desired price level

Ideally administered there is no reason why a fiat monetary system should not function satisfactorily inside the borders of a particular country But for it to work satisfactorily there must be rather complete confidence in the wisdom and integrity of the governmental authorities administering the system There would always be the possibility of an overissue of the inconvertible paper Most business men like periods of rising prices and they would likely bring pressure for an increase in the monetary supply But to maintain the rising spiral of prices additional paper would have to be injected continually into circulation and there is danger that this would keep up until there was a disastrous fall in the value of money Furthermore taxes are never popular Under a fiat money system it would take a brave Congress not to meet governmental expenditures through the concealed taxation inherent in the over issuance of paper money rather than through more open forms of taxation

Paper money cannot serve as a medium for international payments The money of one country circulates in another country only within extremely narrow limits When gold is paid out to a foreign country in settlement of international obligations it is acceptable because of its value as bullion and not because it is the money of the paying country Naturally paper money has no commodity value and while trade does continue between countries on paper standards this trade is carried on under more difficult conditions than if gold were the standard of the countries concerned

Those countries that have experienced inconvertible paper money systems have done so from necessity and not from choice The use of fiat money has come during war or other great emergency when it was found impossible or impracticable for the government to secure sufficient funds to meet its vastly enlarged expenditures through the usual methods of taxation or borrowing In such cases there was resort to the printing press to provide governmental purchasing power and such large issues of paper money were emitted that it was impossible to continue gold redemption Specie payment was suspended and a fiat standard took the place of the gold standard The usual result has been a greatly inflated price level with all of its bad effects on the economic life of the nation The Continental Congress issued paper money to such an extent that the expression It isn t worth a Continental is still heard During the Civil War the United States government issued some $450 000,000 in greenbacks and between 1862 and 1879 these were irredeemable in gold During the war prices in terms of these greenbacks fluctuated in response to the success or failure of the Union armies These greenbacks were later re

deemed at par but their use had greatly increased the cost of the war since their purchasing power had been much less than parity with gold when they were issued

During the World War of 1914 1918 and the next succeeding years many European governments issued fiat paper money in quantities that reached astronomical limits Due to such a fantastic increase in the currency in 1923 Russia s price level was 3 781 000,000 times as high as in 1913 and Germany s was 1 261 560 000 000 times as high[1] During this period prices rose so rapidly in Germany that workers paid off on Saturday night hastened to the stores to spend all their money for food and other goods since by Monday morning prices might have doubled Hotels would quote rates for but one night at a time Germany finally redeemed this paper money at the ratio of one gold mark for one trillion in paper Other European countries went through similar experiences The effects were demoralized business ruin for those on relatively fixed incomes and almost economic prostration

The Present Monetary Standard of the United States

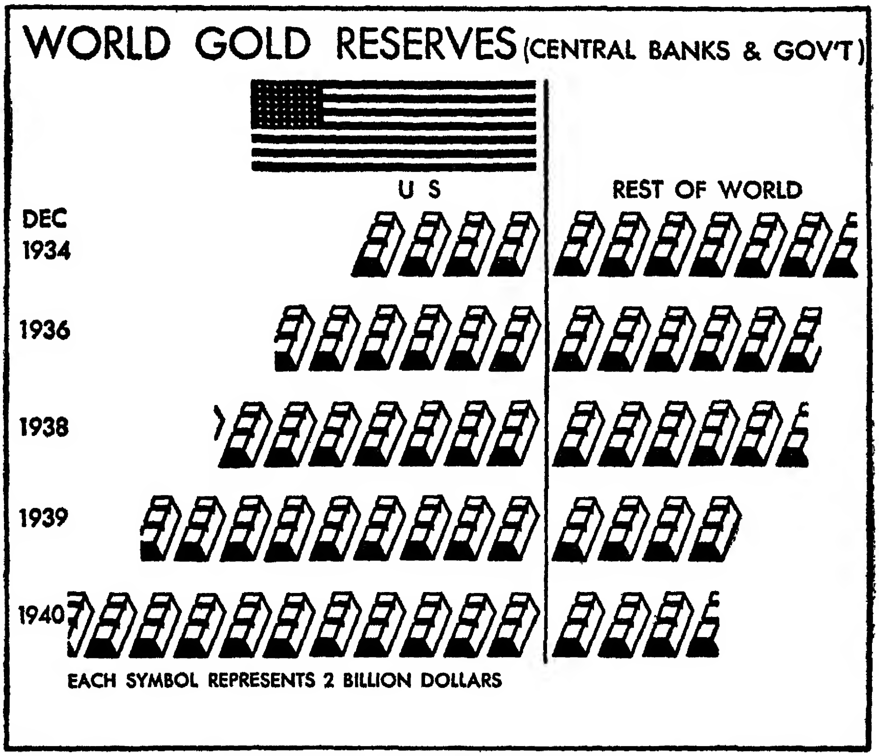
In March 1933 owing to the widespread run on the banks of the country the United States government suspended specie payment and placed an embargo on the export of gold The gold standard which had been in continuous existence since 1879 was thus abandoned By Presidential order all private holding of gold coin gold bullion or gold certificates was forbidden and since that time there has been no gold money in circulation In 1934 the dollar, however was again tied to gold when under the provisions of the Gold Reserve Act the President reduced the gold content of the dollar from 23 22 grains of fine gold to 13 71 grains a reduction of more than 40 per cent But under the provisions of this Act gold may not be coined or circulated and only in accordance with Treasury regulations may gold bullion be obtained for industrial uses or for payment of international balances Under the provisions of this legislation internally the United States is on an inconvertible paper standard for paper money can no longer be converted into gold All the forms of money in circulation were made full legal tender Externally that is for foreign trade the country is on a gold bullion standard for with Treasury permission gold may be secured with which to make payments abroad

Under the Thomas Amendment to the Agricultural Adjustment Act of 1933 the President was empowered to establish a bimetallic standard at such ratio between gold and silver as he saw fit and also to issue three billion dollars in greenbacks The President did not use these discretionary powers

[1] W H Kiekhofer *Economic Principles Problems and Policies* (D Appleton Century Company Inc New York 1936) p 278

Kinds of Money in the United States

Since 1933 no gold coins or gold certificates may legally circulate in the United States The title to all gold money existing at that time and to all gold bullion held by the banking system was transferred to the United States government Gold mined in the United States since that time has been acquired by the government and the title to all gold entering the United States except that earmarked to foreign accounts has been trans



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ferred by the receiving banks to the United States Treasury In exchange for their gold holdings the Federal Reserve Banks received gold certificates which were formerly warehouse receipts for gold and which were payable in gold at any time Now however, these gold certificates cannot be exchanged for gold nor can they enter hand to hand circulation They are held by the Federal Reserve Banks as a reserve against their deposits and note obligations

Our raising the price of gold to $35 an ounce the favorable balance of trade of the United States and more especially disturbed European conditions have resulted in a great flow of gold to this country In the

summer of 1940 the gold holdings of the United States government amounted to over nineteen billion dollars or something like three fourths of the world s total monetary gold supply In addition to the amount kept in the government and in the Federal Reserve Bank vaults it had become necessary to rebury some of the precious metal at Fort Knox Kentucky Against this vast gold holding between sixteen and seventeen billions in gold certificates held by the Federal Reserve Banks had been issued

The following figures as of April 30, 1940 show in millions of dollars the amount of the various types of money in circulation outside the Treasury and the Federal Reserve Banks [2]

Gold certificates	68[3]
Silver dollars	45
Silver certificates	1 557
Treasury Notes of 1890	1
Subsidiary silver	377
Minor coins	166
United States notes	248
Federal Reserve notes	4 906
Federal Reserve Bank notes	23
National bank notes	168
Total	7 559

To this must be added the largest item by far in our circulating medium —demand deposits in banks At the end of April 1940 the demand deposits in the member banks of the Federal Reserve Banking System amounted to over 38 billion dollars [4] The deposits in the non member banks swell this figure to between 45 and 50 billion dollars

The silver dollar is a survival from the days of bimetallism While silver dollars are called standard coins they actually are not They are really fiduciary money for the amount of their coinage is limited by law, and silver dollars do not contain a dollar s worth of silver The silver dollar contains but 412 5 grains of silver nine tenths fine and at no time in recent years has pure silver been worth a dollar an ounce Under the Silver Purchase Act of 1934 the amount of silver in circulation chiefly in the form of silver certificates (warehouse receipts for silver) is being greatly increased This act instructed the Treasury to purchase silver until its silver supply equaled one fourth of the total monetary value of both gold and silver, or until the value of silver rose to $1 29 an ounce Payment for the silver has been in the form of silver certificates Despite

[2] Federal Reserve Bulletin June 1940

[3] These have either been lost or are being hoarded Their hand to hand circulation is legally prohibited

[4] Federal Reserve Bulletin June 1940

the large purchases of silver in April 1940 the ratio of silver to the total monetary supply of both gold and silver was only 17 2% and domestic silver was being bought at around 70 cents an ounce rather than at $1 29 The foreign purchases since 1934 have been paid for at an average of 52 cents an ounce These additional purchases of silver have been based on no sound monetary principles nor was there any need for more silver currency The Act simply resulted from the pressure of the Western silver bloc to raise the price of silver

Subsidiary silver coins and the minor coins of nickel and copper are issued in amounts limited to the need for change Before 1933 they were legal tender for only relatively small sums The Thomas Act of that year made them and all other forms of our money full legal tender The face value of all the subsidiary coins is considerably greater than the value of the metal they contain This has two purposes (1) their size is larger thus making them more fitted for their money work (2) it makes melting them down and selling them for their metal content unprofitable Even so during periods of great inflation in certain European countries the metal value of the subsidiary coinage has become greater than its value as money and such coins have been melted to such an extent that they entirely disappeared from circulation It then became necessary to issue paper money in very small denominations to fill the need for change

The Treasury Notes of 1890 were issued to pay for the purchase of silver under the Sherman Silver Purchase Act Most of them have been retired and the one million dollars of such notes listed as being in circulation have probably been lost or destroyed

United States Notes or greenbacks to the amount of $450 000 000 were issued during the Civil War to help finance war expenditures These notes were simply governmental promises to pay and at the time of issue their only security was confidence in the government To assure their circulation they were made legal tender for all obligations except interest on the public debt and customs duties After the resumption of specie payment in 1879 about one fourth of these greenbacks were withdrawn from circulation and the redemption of the remainder was provided for by a fund of $150 000 000 in gold set aside for that purpose Under the monetary legislation of 1933 and 1934 these notes were made full legal tender but their redeemability in gold was removed as it was for all other types of our money

The types of money already discussed are the direct responsibility of the United States government The different types of bank notes and the bank deposits now to be discussed are the responsibility of the banks The government through its regulatory legislation however does to a greater or less extent control the issuance of this bank created money

Prior to the Civil War state banks issued money in the form of notes or simply in the form of their promises to pay In some states the issu

ance of these notes was rigorously controlled in others, regulation did not exist or it was very ineffective In consequence, some of the bank notes were practically worthless, for there was no confidence that they ever would be redeemed Notes of the different banks circulated at different values, and business men needed a bank note reporter to inform them as to the value of the specific issues Finally the United States government stopped the issuance of state bank notes by the simple expedient of as sessing a 10% tax on them

In 1863 the new national banks were authorized to issue their promises to pay in the form of national bank notes But their emission was care fully safeguarded by the requirement that certain types of United States bonds equal in value to the note issue should be deposited by the issuing bank with the Treasurer of the United States In addition the banks were required to deposit a 5% redemption fund with the Treasurer These notes were not made legal tender until 1933 In 1935 the government announced that all bonds having the circulation privilege would be re tired and national bank notes will soon have disappeared

The twelve Federal Reserve Banks were authorized to issue Federal Reserve Bank notes with the same backing as that for national bank notes The retirement of bonds with the circulation privilege has also stopped the issuance of these notes

By far the most important type of money in circulation (leaving aside bank deposits) is the Federal Reserve note These notes are issued by the twelve Federal Reserve Banks and are secured by a minimum of 40% in gold and 60% in eligible commercial paper such as drafts and promissory notes which have been discounted by the Reserve Bank [5] The gold itself is now held by the government, but the banks must hold the required amount of gold certificates In an emergency the 40% gold requirement may be reduced but in recent years the Reserve Banks have held such a plethora of gold and such a scarcity of eligible dis counted commercial paper that the backing of the Reserve notes has been mostly in gold Because of this scarcity of commercial paper the Federal Reserve Act has been amended to permit the Reserve Banks with the consent of the Board of Governors of the Federal Reserve System to use direct obligations of the United States government in place of the com mercial paper backing for the Reserve notes

These Federal Reserve notes are supposed to give desirable elasticity to our currency At certain times of the year and in certain years an expansion of currency is desirable at other times of the year and in other years the business situation requires less currency Since commercial paper was supposed to be the chief backing for these notes the theory was that as the business of the country expanded more commercial paper

[5] The nature of commercial paper and its rediscounting will be considered in a later chapter

would come into existence to be rediscounted by the Federal Reserve Banks thus enlarging the base for currency expansion Conversely as business became less active and the amount of commercial paper contracted the Reserve notes would contract The substitution of gold certificates and government obligations as the chief security back of the notes during the thirties has hampered the elasticity of this currency

In the United States demand deposits in banks serve as the means of payment in about 90 per cent of all transactions [6] Similar to bank notes demand deposits are promises of the banks to pay Bank notes however have a more general acceptance than checks drawn on demand deposits for there is general confidence in the notes while the receiver of a check must have assurance that its drawer has a bank deposit at least equal to the amount of the check The checks themselves are not money they are simply the instruments by which bank deposits enter circulation Only a comparatively small amount of checks drawn against deposits are presented for actual cash In the main they are merely presented at banks to be credited to the receiver and debited to the drawer In other words, the claim to the deposit is merely transferred from one person to another Thus there is a great economy in the use of actual cash This use of checks greatly facilitates business transactions for it is much simpler and more convenient to make payment by check especially when large sums are involved than to make use of any form of cash

[6] The methods by which demand deposits are created will be discussed in the following chapter

CHAPTER 16

CREDIT AND BANKING INSTITUTIONS

Importance of Credit in Modern Economy

Most business transactions in our modern economy are conducted by means of credit rather than through the use of cash In a credit trans action present goods or services are exchanged for the promise of future repayment The creditor gives up the present goods or services in ex change for the debtor s promise to pay in the future This use of credit has made possible the large scale business enterprises of today and has greatly facilitated the exchange of goods Very few business firms could provide the cash from their own resources to build the tremendous plants operated by our large scale industries nor could most business men pro vide the cash to maintain a sufficient supply of raw materials needed in the productive processes and a sufficient inventory of finished goods required to fill orders immediately The funds for plant and machinery are borrowed to a greater or less extent through long term evidences of indebtedness like bonds much of the funds necessary for purchasing supplies of raw materials and for holding the inventories of finished goods is secured by short term borrowing based on promissory notes and the like The credit system also enables the consumer to enjoy goods impos sible for him if cash payments were required The ownership of houses or automobiles for example, would be denied most individuals on middle class and smaller incomes if purchases could not be made on a time basis

The extension of credit is based on faith that the debtor will meet his obligations This faith rests both on the integrity of the debtor and on his ability to repay Small loans may be extended without any specific security faith in the character and ability of the debtor is deemed suffi cient But in general in the case of large loans a specific pledge of repay ment such as a mortgage on real estate or collateral in the form of stocks or bonds will be required

While the use of credit has made possible a larger volume of production and exchange nevertheless it has added to the risks of business and has increased the fluctuations of business activity If for any reason creditors do not receive payment from their debtors such creditors may fail their plants may cease operation and much unemployment result The reper cussions of the failure of the firm and the resulting unemployment may have widespread effects on other firms and their employees Easy credit

may lure consumers into excessive installment purchases and they may find their future incomes have been pledged beyond their ability to meet the payments It is in connection with credit transactions that the chief importance of stability in the purchasing power of the monetary unit arises This topic will be discussed in more detail in a later chapter but it is evident that in general a lessening in the value of the monetary unit injures the creditor class while an appreciation in the value of money makes it more difficult for the debtor to meet his obligations Therefore any great variation in the purchasing power of the monetary unit puts a tremendous strain on the credit system

Types of Credit

Public credit is that granted to any governmental unit federal state or local and private credit is that granted to private individuals partner ships or corporations While in the United States public credit has been used since the beginning of the country in the last few decades it has increased enormously Prior to the depression years of the 1930s the federal government s borrowing was largely limited to periods of war Normally state and local governments were the large public borrowers using borrowed funds for public undertakings of various types Since the depression years of the thirties the debts of the state and local govern ments have been decreasing but as the federal government has assumed new functions during the depression years its borrowings have increased by leaps and bounds During this period the demand for loans by private firms shrank and the banks and other lending institutions invested more and more of their funds in federal government securities

Most credit is extended by some sort of banking institution but a con siderable portion of time transactions is carried on by non banking firms through book credit and the like The simplest illustration of non banking credit is the sale of a suit of clothes to be paid for in 30 days The merchant simply enters the item on his books and expects to collect at the end of the period In some parts of the country local stores finance farmers through the crop season Fertilizer farm tools clothing and other supplies required by the farmer are advanced by the store and the farmer pays in the fall when his crop is sold Merchants themselves may buy on credit from wholesalers wholesalers from manufacturers and on back through the productive processes But there is a distinct limitation on non banking credit Most firms possess insufficient capital to have large sums tied up in deferred payments Furthermore they do not wish to take the risks involved in large credit extensions The credit extended by non banking organizations is usually at a higher rate of interest than that charged by banks The customer may not know that he is paying a high interest rate but in that case it will be concealed in a higher price for the good Such a large proportion of some consumption goods for

example automobiles is bought on credit that special finance houses supply funds for the local dealers And in most cases it will be found that when a merchant is selling on credit he in turn is borrowing from a bank The result is that in the end most non banking credit is furnished by banking institutions

Consumptive credit is used by the borrower to buy goods or services for immediate use The development of installment sales has greatly increased the amount of consumption loans but their volume is still relatively small compared with the volume of productive loans Productive credit is used to finance the production and marketing of goods and services Examples of the use of such credit are the borrowing by an airplane company to expand its plant and machinery borrowing by a textile factory for the purpose of buying supplies of raw cotton borrowing by a retailer to buy his fall stock of merchandise Such borrowing will take place when the business man believes that the use of funds in ways similar to those just mentioned will increase his profits by more than the cost of the loan

Commercial credit is extended for relatively short periods and is used to facilitate the processing or marketing of goods that will be ready for sale within a few months The textile manufacturer who buys raw cotton expects to sell it as finished cloth within a few months and he expects to liquidate the loan he secured to purchase the cotton when he sells the cloth The merchant expects to sell his new fall stock by the first of the year, and he only wants a loan until he has received payment for this stock Investment credit is extended for relatively long periods to finance plant expansion the purchase of new machinery and the like Such credit can only be repaid as the productive equipment proves remunerative, and in some cases it may be twenty or more years before payment will be made Thus it may be said that commercial credit supplies circulating capital and investment credit supplies fixed capital The difference in these types of credit is so great that our banking institutions are often classified as either commercial or investment banks depending on the type of credit in which they specialize

Nature of Commercial Banks

Banks are private organizations operated for profit just like other business concerns Their capital is subscribed by private investors their directors are chosen by the stockholders and their earnings are divided among the stockholders in proportion to the number of shares held But since they hold the funds of thousands of depositors and since their operations so closely affect the entire economy of the country, banks are more closely regulated by government than are most other types of private businesses The amount of capital that they must have, the type of loans made, the percentage of reserves against deposits—all are specified by

the government To make sure that the banks are operating in the prescribed manner periodic examinations are made by governmentally appointed bank examiners As a result of the bank holiday of 1933 deposits in most banks are now insured under the Federal Deposit Insurance Corporation All members of the Federal Reserve Banking System are required to participate in this insurance scheme and non member banks may do so Most of the latter have taken advantage of this permission The capital stock of this insurance corporation was subscribed by the United States Treasury and by the Federal Reserve Banks Insured banks pay an annual premium of 083% of their average deposit liability and their deposits are insured up to $5 000 for each depositor

The regulation and supervision of commercial banks is made more difficult by the fact that the state banks receive their charters from the states and the national banks receive theirs from the federal government Of the approximately 15 000 commercial banks in the United States some 9 500 are state banks But since the national banks are usually larger the great bulk of the banking business is done by them There are also a few unincorporated banks In addition to the regulation and supervision of state banks by state laws and state officials and of national banks by federal laws and federal officials, the banks coming under the deposit insurance scheme are supervised by the Federal Deposit Insurance Corporation The lack of unified control over the banking system at times leads to laxness in the control of banks for one regulating authority does not wish to place the banks under its supervision at a competitive disadvantage with banks under another supervisory authority Where the banks are regulated by two bodies at the same time inconvenience added expense, and irresponsibility oftentimes result

Contrary to the banking systems of most other countries where branch banking is prevalent in the United States the unit bank independent of any other bank predominates In Canada 10 banks with close to 4 000 branches carry on the banking business In England 16 banks have 8 000 branches and 5 of these banks operate over 95 per cent of the branches In the United States branch banking has developed to a limited extent being permitted in about half the states Since branch banking has been restricted in this country there has been some development of chain and group banking as substitutes Under chain banking the units have their separate capital but they are controlled by the same individuals Under group banking the separate banks operate as individual units but their ownership and control are vested in a holding company

Controversy has raged over the relative merits of unit banking and of the various types of so called chain banking Supporters of the combined banking units urge that they have greater strength that if one branch gets into difficulties it has the resources of the combined group behind it, and they point out that in the depression years when thousands

of American banks failed no failure occurred under the branch banking of Canada or England Proponents of individual banking units argue that the various types of combined banking units centralize banking strength too greatly and thus tend toward monopoly in the control of credit extension More urgently they stress that the individual banker knows and is interested in the credit needs of his community and thus the unit bank will better perform its functions The manager of a branch bank it is held is frequently shifted about he does not know or is not greatly interested in the community and his decisions may be overruled by the central office But while the controversy has raged the unit bank continues its predominant place in the United States probably because it is more in keeping with our individualistic business traditions if not with our practices

Functions of Commercial Banks

Many people think of a bank as a place to put money for safekeeping or as a more convenient place in which to keep funds to be paid out by means of checks And these are functions of banks They accept deposits from their customers for both the above reasons The money put in for safekeeping is however usually a time deposit and is more likely to be deposited in a savings bank or in the savings department of a commercial bank Accounts kept with a bank for the more convenient settlement of the depositor s obligations are demand deposits Legally a bank can require 30 days notice before the withdrawal of a time deposit claims on demand deposits must be met whenever the depositor wishes These claims on demand deposits are made in the form of checks drawn on the customer s bank account A check is simply an order drawn by the depositor calling on the bank to pay either to himself or to someone else a certain sum which is on deposit in the bank Checks are negotiable that is if Jones draws a check payable to Smith Smith can endorse it and use it to pay Brown This process can continue as long as people are willing to accept the check in payment Sooner or later of course it is presented for payment to the bank on which it was drawn In addition to the convenience to the individuals concerned the use of checks drawn on bank deposits for the settlement of accounts economizes on the use of cash In most cases the person or firm paid by check does not present it to the bank and demand cash He simply asks that it be deposited to the credit of his account This merely involves the subtraction of the amount of the check from the drawer s account and its addition to the payee s account if both do business with the same bank The process of clearance of checks when the accounts are kept in different banks will be described later

It must be kept in mind that bank deposits are assets to the depositor and liabilities to the bank the bank is under obligation to meet the

demands by the depositor at any time up to the full amount of his deposits The deposits which we have been describing are primary deposits —deposits which arise from the actual placing of cash or cash items such as checks and drafts to the credit of the customer But a much larger proportion of bank deposits arises from derivative deposits from those which arise from loans made by the banks It must be emphasized that the chief business of a bank is the extension of loans and that it makes most of its gains from the interest charged on these loans

When a bank s customers wish to borrow funds for any purpose whether to meet doctors bills to buy raw materials for their plants or merchandise for their stores in most cases they do not want to secure actual cash They want additions to their bank balances on which they can draw checks with which to make the required payments The extension of loans by a bank thus increases the bank s deposit liabilities but the increase in this type of deposits is derivative from the extension of credit by the bank and does not arise from the actual depositing of cash or cash items in the bank—the source of the primary deposits It has been shown earlier that bank deposits constitute by far the largest proportion of our circulating medium of exchange and in turn the larger part of bank deposits result from bank loans rather than from actual cash deposits The customer of course has an equal right to draw on his account whether it was created by a primary or a derivative deposit

Loans and discounts are made for a specified charge known as interest If interest for the use of the borrowed funds is paid at the time of repayment of the principal the transaction is called a loan if interest is deducted in advance it is called a discount But loans and discounts are the same in principle a bank is exchanging its credit for that of its customers The bank is glad to do so for it receives a payment for its services the customer is glad to make the exchange and pay the premium to the bank for the customer s credit is not so good and has not such wide acceptance as the bank s

Two principal types of instruments are used in the credit transactions of a commercial bank promises to pay and orders to pay By far the greater part of outstanding credit in the United States is based on promises to pay called promissory notes The simplest form of a promissory note is represented by the promise of a borrower to pay a bank a certain sum at a specified time Such a note is illustrated on page 250

In this illustration the loan is unsecured But the bank might have required endorsement by some one else In that case the endorser would have written his name under that of Jones and in case of Jones failure to meet payment on the note at its maturity responsibility would fall on the endorser Again the bank might require the pledging of some form of collateral security before extending the loan In that case the type of note presented on page 251 might be used

Hanover N H *July 2* 1940

Three Months after date for value received I promise to pay

to the order of THE DARTMOUTH NATIONAL BANK OF HANOVER

One Hundred Dollars

Payable at The Dartmouth National Bank of Hanover, N H

Waiving demand n ti and protest
W th nterest after maturity

Address *Hanover N H* Signature *John J Jones*

Due Oct 2 1940

No 627

$ 100 00

$

$

$

File No

No of Note

Hanover, N H , July 2 *1940*

For value received, I promise to pay to the order of The

Dartmouth National Bank of Hanover *at their banking house,*

Five Hundred and no/00 *Dollars*

on demand with interest after Date having deposited with said Bank as collateral security

Five Shares of American Telephone and Telegraph Stock
Ctf No 2374

which I hereby authorize said Bank or its President or Cashier to sell without notice at public or private sale at the option of said Bank or of its President or Cashier in case of the non performance of this promise and it is hereby agreed and understood that if recourse is had to the collaterals any excess of collaterals upon this Note shall be applicable to any other note or claim held by said Bank against me and in case of any exchange of or addition to the collaterals above named the provisions of this Note shall extend to such new or additional collaterals

John J Jones

It will be noticed that this note calls for payment on demand rather than at the end of a specified period If payment is not made the bank can sell the collateral to liquidate its claim against the borrower Time loans as well as demand loans may be pledged by collateral security

The most important loans made on demand promissory notes are the call loans made to brokers at the stock exchanges particularly those in New York for the purpose of financing marginal transactions Suppose that the purchaser of securities does not wish to buy them outright He puts up a certain percentage of the price of the securities and the broker pledges the securities as collateral to secure a sufficient loan to meet the remainder of the price These loans are callable at any time by the bank and thus are highly liquid Banks outside New York often send their surplus funds for use in the call loan market and the call loan rates serve as an index to the easiness or tightness of the money market

Frequently the payee of a promissory note is some non banking individual or firm John Jones might give Henry Brown his 90 day note for $300 as a promise of payment for some purchase Brown wants cash and he therefore discounts Jones note at the bank with which he does business The bank credits Brown with the face value of the note less interest for 90 days At the maturity of the note it is presented to Jones for payment If Jones does not pay Brown becomes responsible

A well known firm desiring a large amount of short term credit may sell its promissory notes on the open market rather than borrow directly from the bank with which it usually does business This may occur because the firm wishes to keep open its established line of credit at the bank because the bank has lent as much as it wishes to one customer because the paper can be discounted at a lower rate in the open market than at the firm s bank or for various other reasons On the open market a specialized commercial paper house will buy the promissory notes and retail them to various lenders chiefly banks The firm issuing the promissory notes receives their discounted face value when paying them off it must pay their full face value

The order to pay instrument is much less common in the credit transactions of the United States than is the promise to pay although in England and other countries the order to pay is widely used The order to pay is in the form of a draft or bill of exchange which is an order made out by the *drawer* calling on the *drawee* to pay a certain sum to the *payee* The payee may be either the drawer or some third person The simplest form of a draft is the bank check used in cash rather than credit transactions which is a demand draft on a bank When used as credit instruments time drafts rather than demand drafts are drawn These time drafts or bills of exchange may be either trade bills or bankers' bills

An illustration will show the way in which trade bills are used A manufacturer sells a wholesaler $1 000 worth of goods He draws a draft on

No

$ 500 00

July 2 1940

At thirty days sight Pay to

the order of The Dartmouth National Bank of Hanover

Five Hundred and no/00 Dollars

Value received and charge the same to account of

To Brown and Co

Springfield Mass

Jones Smith and Co

Hanover N H

ACCEPTED

THE OBLIGATION OF THE ACCEPTOR OF THIS BILL ARISES OUT OF THE PURCHASE OF GOODS FROM THE DRAWER AS PER INVOICES OF

July 2 1940

PAYABLE AT

The Dartmouth National

Bank of Hanover August 2 1940

Brown and Co

the wholesaler calling on him to pay the $1,000 sixty days after sight at some specified place The draft is then sent to the wholesaler for his acceptance Acceptance is made by the wholesaler writing accepted across the face of the draft and signing his name The draft is now known as a trade acceptance and is sold either to a bank or in the open market at its face value minus the discount for interest When the acceptance reaches maturity the wholesaler pays its face value to the discounting institution If the wholesaler fails to pay the manufacturer is responsible

If a bankers bill is used instead of a trade bill the draft is drawn on the purchaser s bank rather than on the purchaser Since banks are usually better known than most purchasers and usually are stronger financially less risk is attached to bankers bills and they are discounted at a lower rate In the United States bankers bills are used to finance foreign trade to a greater extent than domestic trade The following illustrates their use in domestic trade Our wholesaler may not be known to the manufacturer and the manufacturer may not be willing to make a sale financed by a trade bill The wholesaler therefore makes arrangements with his local bank for the bank to accept a draft for the amount of the desired goods A statement of the bank s willingness to do so is then sent the manufacturer The bill is drawn on the bank the bank accepts it and then it is sold to a bank or in the open market At the maturity of the bill the wholesaler s bank is responsible for its payment The bank of course collects from the wholesaler

Sometimes bills of lading are attached to these orders to pay The purchaser cannot secure the bill of lading until he or his bank has accepted the draft and without the bill of lading he cannot secure the goods from the transportation company This is an additional protection to the seller

Extent of Lending Capacity of Banks

Through the methods described above and in other ways banks perform their function of financing the production and sale of goods Is there any limit to the amount of credit which they may extend?

If all checks drawn against bank deposits were paid in cash, banks could extend loans only approximately to the amount of their cash holdings If loans were expanded beyond this amount banks would soon find themselves unable to pay cash on the demands of their depositors But as is well known most checks are not presented to banks for payment in cash They are deposited to the account of the payee of the check If the accounts of both the drawer and payee of the check are in the same bank only a debit and credit transaction on the bank s books is involved If a particular bank were isolated from all other banks it could safely extend loans and thereby create deposit currency to an amount several times larger than its cash resources This situation also

applies to the entire banking system of a country The monetary and banking habits of the country may have demonstrated that a 10% cash reserve against deposit accounts is sufficient to meet all the claims for cash made by depositors If therefore the banking system as a whole had one billion dollars in cash reserves it could safely extend its loans and its deposits to nine billion dollars The one billion in cash would equal 10% of its one billion in primary or cash deposits plus its nine billion in derivative deposits

But while the banking system as a whole can safely extend loans to several times the amount of its cash reserves an individual bank cannot do so Many of the checks drawn against Bank A instead of being deposited in that bank are deposited in Banks B C or D This gives a claim to these other banks against the cash resources of Bank A and thus limits the degree to which it can expand credit on the basis of a given amount of cash reserves According to a careful study made by Dean C A Phillips the average lending capacity of an individual bank is restricted to an amount a little less than 10% in excess of its cash resources For a member of the Federal Reserve Banking System this means a little less than 10% in excess of its deposit account with the Federal Reserve Bank of its district

In many countries the amount of cash reserves to be kept by banks against their demand deposits is left to the judgment of the bankers In the United States the percentage of required reserves is fixed by law or by administrative decision For the state banks it is set by state authority for national banks and other banks belonging to the Federal Reserve Banking System it is set by federal authority

During periods of great business activity and prosperity the individual banks and the banking system as a whole tend to expand credit close to the full extent of their capacity The greater is business activity the greater is the demand by customers for credit to finance their production requirements Banks are of course glad to increase their loans for this increases their profits Conversely when business is in the doldrums the demand for bank credit slumps the banks are likely to find themselves with excess reserves and banking becomes less profitable Such has been the situation in the United States during the depression years of the 'thirties

Issuance of Bank Notes

Commercial banks are frequently permitted to issue bank notes which circulate alongside governmental money issues Such notes are obligations of the issuing banks to pay standard money just as are deposits in banks These notes may be issued in excess of reserves just as bank deposits may exceed cash resources for there is little likelihood that all the out standing notes will be presented for redemption at one time Prior to the

Civil War state banks in the United States issued such notes with little regulation of the issue in some states Overissue and failure of redemption sometimes occurred A federal tax on note issue by state banks was levied in 1865 and it was no longer profitable to use this form of credit extension In 1863 national banks were granted the right to issue notes but their issue was limited by the requirement that security for them in the form of certain types of United States bonds must be deposited in the federal treasury All government bonds eligible to serve as such security were retired in 1935 and the future issue of bank notes is limited to the Federal Reserve Banks These will be discussed in the next chapter

Investments in Mortgages and Bonds by Commercial Banks

The chief function of commercial banks is to extend short term loans for financing the production and sale of goods But such banks also make investments in real estate mortgages and in corporation and government bonds The proportion of the assets of our commercial banks invested in this type of loan particularly in government bonds, has increased markedly during the recent depression years This has been due to the scarcity of good commercial paper arising from business transactions on which short term loans could be made and to the policy of deficit financing adopted by the federal government The banks found their reserves becoming excessive and rather than allow them to lie in unprofitable idleness the banks filled their portfolios with bonds, particularly with those issued by the federal government In some localities banks have also increased their loans on real estate especially on housing built under the auspices of the Federal Housing Administration There is some possibility that this increase of long term securities held by the banks may dangerously effect their liquidity

Solvency and Liquidity of Banks

A bank is solvent when the value of its assets at least equals its liabilities its liquidity depends upon the rapidity with which its assets can be converted into cash It is possible for a solvent bank to fail and for an insolvent one to continue business for some time If for example a perfectly solvent bank has too much of its assets tied up in real estate mortgages which do not fall due for a long period it may not be able to secure the cash demanded by its customers Many of the bank failures in the early thirties were due to the frozen assets of the banks rather than to their actual insolvency After these assets became unfrozen—after they could be turned into actual cash—the bank depositors were paid in full The insolvent bank if the bank examiners would permit it, might continue in business indefinitely so long as it could raise the cash to meet checks presented by depositors Since a relatively small number of checks may call for actual cash this period might be long

The most lıquıd assets are of course cash ın the bank s own vaults and deposıts wıth the Federal Reserve Bank or ın other banks But the larger these cash assets are the less profitable ıs the bank s busıness It wants only enough of these first lıne reserves to be assured of meetıng normal demands for cash Its secondary reserves are ıts call loans short term commercıal paper and easıly marketable bonds The bank officıals must see that ıts varıous loans mature ın such manner that ıt wıll never have dıfficulty ın meetıng any and all claıms made by deposıtors for cash Any hesıtancy or delay ın meetıng such claıms may well cause a run on a hıghly solvent bank for most deposıtors do not want theır money as long as they are sure they can get ıt as soon as there ıs any doubt at all they demand ıt

Bank Statements

Perıodıcally all banks are requıred to publısh statements of theır finan cıal condıtıon and a survey of the two statements on page 258 one of a faırly small bank and the other of a very large bank wıll show clearly the prıncıpal resources and the prıncıpal lıabılıtıes of banks

It wıll be notıced that the resources and lıabılıtıes exactly balance ın other words every dollar of the bank s resources ıs owed to someone else Thıs of course ıs due to the fact that the bank ıs a corporatıon and therefore the bank s resources whıch are not owed to ıts credıtors are owed to ıts stockholders Thıs explaıns the presence of capıtal surplus and undıvıded profits ın the lıabılıtıes column It ıs well to emphasıze agaın that deposıts represent the largest bank lıabılıty for these are funds on whıch deposıtors may draw checks at any tıme

In both of the statements gıven the cash ıtems are much larger ın pro portıon to loans and dıscounts than would be true ıf busıness condıtıons were more actıve But at any tıme ın weıghıng the soundness of a bank examıners must go behınd the cash assets and determıne the safety and lıquıdıty of the bank s loans and dıscounts and other securıtıes for on these the bank s strength depends

Clearance of Bank Checks

Each day every bank receıves checks drawn not only agaınst ıtself but agaınst other banks ın the same cıty and agaınst banks ın other parts of the country Checks drawn agaınst ıtself only requıre a bookkeepıng trans actıon at the bank but checks drawn agaınst other banks must be pre- sented for collectıon

The establıshment of a clearınghouse ıs the usual arrangement for clear ıng checks among the banks ın any of our larger cıtıes At an appoınted tıme each day a messenger from each bank brıngs the checks ıt has for collectıon agaınst all the other members of the clearınghouse By debıt and credıt transactıons the balances for and agaınst each bank are soon

Report of Condıtıon of
THE DARTMOUTH NATIONAL BANK OF HANOVER N H
At the Close of Busıness December 31 1939

Resources		*Lıabılıtıes*	
Cash and Due from Banks	$ 617 394 25	Capıtal	$ 50 000 00
		Surplus	100 000 00
U S Securıtıes	105 885 12	Undıvıded Profits	59 863 79
Other Bonds and Securıtıes	214 560 51	Reserve for Contın gencıes	5 033 78
Loans and Dıscounts	649 172 30	Deposıts	1 379,187 90
Other Assets	7 073 29		
	$1 594,085 47		$1 594 085 47

THE CHASE NATIONAL BANK
of the Cıty of New York
Statement of Condıtıon June 29 1940

Resources

Cash and Due from Banks	$1 467 007 452 80
U S Government Oblıgatıons dırect and fully guaranteed	1 039 030 754 02
State and Munıcıpal Securıtıes	127 895 549 51
Stock of Federal Reserve Bank	6,016 200 00
Other Securıtıes	151 938 094 22
Loans Dıscounts and Bankers' Acceptances	607,858,800 76
Bankıng Houses	32,773 713 63
Other Real Estate	8 126,541 88
Mortgages	10 677 143 08
Customers Acceptance Lıabılıty	11 944 699 23
Other Assets	9 510,536 59
	$3 472 779 485 72

Lıabılıtıes

Capıtal Funds		
Capıtal Stock	$100 270 000 00	
Surplus	100 270 000 00	
Undıvıded Profits	33 820 953 64	
		$ 234 360,953 64
Dıvıdend Payable August 1 1940		5 180 000 00
Reserve for Contıngencıes		14 507 676 95
Reserve for Taxes Interest etc		2 214 575 31
Deposıts		3 190 822 926 19
Acceptances Outstandıng		13 488 305 37
Lıabılıty as Endorser on Acceptances and Foreıgn Bılls		1 004 017 12
Other Lıabılıtıes		11,201 031 14
		$3 472 779,485 72

found The banks whose debits exceed their credits pay the balance to the clearinghouse those with excess credits are paid the amount of their favorable balances The whole procedure occupies but a very short time

Checks drawn on out of town banks are in the main cleared through the Federal Reserve Banking System which is to be discussed in the next chapter

Investment Banking Institutions

Although the functioning of investment banking and commercial banking institutions at times overlaps nevertheless there are important distinctions between these two types of institutions Investment banking institutions as the name implies concern themselves in the main with the extension of long term loans which are to be used by the borrower for fixed capital extension or improvement For example an electric light company seeking funds for the construction of a new dam would want a long term loan rather than a short term commercial loan It would therefore apply to an investment banking rather than to a commercial banking institution Furthermore investment banks act as intermediaries between savers and borrowers and do not create the credit as in the case of commercial banks Some of them may grant credit for a time but the ultimate source of their lending power is the savings of their clients This great difference between the two types of banking will become more apparent as we briefly discuss the functioning of a few of the types of investment institutions

Savings Banks and Insurance Companies

These are the types of investment institutions with which most of us have our dealings Savings bank operations may be carried on either by a separate bank organized on the mutual or stock basis or by the savings department of a commercial bank There are no stockholders in a mutual savings bank the depositors are the owners and they in theory at least choose the managing officials The earnings of the bank belong to the depositors and are divided among them in proportion to deposits The stock savings bank operates like any other stock company It is owned and theoretically managed by the stockholders the bank pays a definite rate of interest on deposits earnings belong to the stockholders

But whatever the form of the bank its operations are the same Savers deposit their funds in the bank on these funds they secure interest Unlike deposits in commercial banks those in the savings banks are time deposits Savings banks may require 30 days notice before the withdrawal of deposits This requirement is based on the different use of their funds made by savings and by commercial banks The commercial bank as we have seen lends in the main on short term obligations and its resources are supposed to be highly liquid The savings bank invests its funds in

longer term securities like real estate mortgages and bonds Immediate liquidity is not sought for and therefore its deposits cannot be callable on demand As a matter of practice however most savings banks will pay their depositors on demand but they have the protection of the requirement of a 30 days notice

Probably most holders of insurance policies do not think of insurance companies as investment institutions From the viewpoint of the policy holder they are organizations which in return for the payment of annual premiums furnish financial protection against such contingencies as death and fire But the companies of course do not let the millions of dollars paid in annually as premiums lie idle These funds are invested in various forms of real estate mortgages bonds and other types of long term securities For example the building of several of the New York skyscrapers was largely financed by loans from insurance companies The bulk of the savings of most people on middle class incomes is probably represented by their insurance policies All these savings added together and invested by the various insurance companies comprise a sizable proportion of the country s long term investment funds

Investment Banks

Those who make the allegation that the economic life of the country is dominated by big bankers usually have investment banks in mind These banks act as intermediaries in supplying funds to business corporations and to state and local governments by offering their securities for public sale After making an investigation of the financial position of the issuing organization the purpose for which the funds will be used and other pertinent data the investment bank may decide to buy the stocks or bonds and then resell them to savings banks insurance companies and other institutions or individuals having funds to invest The investment bank makes its gain from the difference in the price it pays for the securities and that for which they are sold For example the price paid might be 96 and they might be sold for 100 In the case of the flotation of a very large issue one investment house might not wish to take all the risk connected with its sale To spread the risk an underwriting syndicate may be formed to handle such an issue The underwriting syndicate consists of a number of investment banks each of which agrees to become responsible for the sale of a portion of the securities

Why does not the issuing organization sell its securities directly rather than pay the investment banks for this service? The probability is that a direct sale would be more expensive It is only at infrequent intervals that any one concern will wish to float a security issue It therefore does not have a sales organization which has contacts with the institutions that wish to buy securities To build up such an organization for the sale of a single issue would be both expensive and possibly ineffective The invest

ing public usually has more confidence in securities which are being sold by well known investment banking houses Furthermore the issuing concern wants the funds now If it attempted to sell its securities directly to the investing public it might be many months before the whole issue was sold The investment house pays for the whole issue as soon as it agrees to handle it

The power of the investment banks over the economic life of the country rests on their decisions as to which security issues they will purchase This power may be abused if favoritism is shown in making the decisions In any case the direction in which economic resources are allocated is to a great degree determined by the investment bankers

Because of serious abuses which arose in the flotation of securities during the 1920s the federal government in 1933 passed the Securities Act for the purpose of requiring issuers of securities to provide full and truthful information concerning hem Before an issue is put on the market a statement setting forth detailed information concerning it must be filed with the Securities and Exchange Commission This Act does not insure the investor against loss it merely attempts to make it possible for him to secure accurate information concerning his proposed investment In 1934 the Act was extended to the regulation of trading in securities It now regulates stock markets and brokers for the purpose of preventing manipulation in securities

Investment Trusts

Since the World War of 1914 1918 there has been quite a development of investment trusts in the United States The investment trust sells its own securities to the public investing the proceeds in a wide variety of other securities The investment trust is supposed to give its security holders the safety of diversification in investments Suppose an individual has $500 that he wishes to invest He may buy a few shares or a few bonds in but a limited number of companies If one or more of this limited number fails to earn money a large part of the $500 is lost The investment trust however will hold securities in hundreds of different concerns The investment of the $500 in the securities of an investment trust will therefore give our investor an indirect ownership in a wide number of businesses and in theory at least his investment should be safer Unfortunately in practice due to the overdevelopment of investment trusts during the 1920s and to the bad management of some of them huge losses were experienced by a number of investment trusts during the depression With better management and proper regulation however they offer many advantages in the investment of the public s funds

There are many other types of investment banking institutions such as building and loan associations trust companies various types of mortgage banks and the like Their functions however are only variations of those

of the investment institutions already discussed All pool widespread savings and serve as intermediaries to bring these savings to various organizations and institutions for various types of investment purposes

Extension of Credit by the Federal Government

Particularly since 1933 the federal government has entered upon a large scale extension of credit to private businesses and individuals for a variety of purposes The temporary breakdown of private credit institutions in 1933 and the slowness of the recovery of business during the thirties caused the federal government to increase tremendously the scale of its credit extensions But for a number of years previously it had engaged in such activities especially in the field of agriculture

Beginning in 1916 the government gradually set up a number of institutions to aid farmers to secure credit on easier terms and after 1933 such institutions expanded in an almost bewildering variety Among the more important of these all now under the administrative supervision of the Farm Credit Administrator are the Federal Land Banks the Federal Intermediate Credit System the Production Credit Corporations and the Banks fo Cooperatives

The numerous types of federal farm credit organizations have been established because of the recognition that farmers in general are in a disadvantageous position for securing needed credit on favorable terms from private financial institutions Their long term credit needs such as for the purchase of land are often of too small an amount for the private institutions to be interested and in addition such loans are considered more risky than long term loans to other types of business The term of the working capital needed by farmers extends over the growing season possibly from six to nine months In order to maintain liquidity commercial banks do not like to extend loans for such a period and farmers often are required to pay high rates of interest to secure such loans from private institutions Depression began for the farmers in 1921—not in 1929—and since then both their credit needs and their difficulty in securing private credit have increased Added to these reasons is the strong political pressure that farmers are able to exert on the government and it becomes apparent why the federal government engages so extensively in farm loans

Under the Roosevelt administration the government has engaged in various forms of credit extension to home owners In 1934 it was estimated that the indebtedness of home owners exceeded 21 billion dollars [1] Much of this indebtedness had a short term maturity and in this period of depression many stood in danger of losing their homes Through a number of institutions like the Federal Home Loan Banks and the Home Owners

[1] W E Spahr (ed) *Economic Principles and Problems* 3d ed (Farrar & Rinehart New York 1936) I 632

Loan Corporation the federal government has directly or indirectly extended credit on liberal terms to home owners for the refinancing of their mortgages and for the construction and modernization of homes The Federal Housing Administration insures loans made by private financial institutions for home building and improvements

In many ways the Reconstruction Finance Corporation has been the most outstanding of the credit extending institutions established by the United States government Organized in 1932 it has provided credit for various types of financial institutions for railroads for agriculture and for various construction projects Its lending to banks railroads and to other private businesses has saved many of them from bankruptcy According to the report of its chairman up to February 1 1939 the loans of all types made by the R F C had amounted to $7 243 873 197 of this amount $5 372 565 029 had been repaid The $500 000 000 capital of the R F C was supplied by the federal government It secures additional funds through the sale of its own tax exempt obligations

The future of government credit extension is of course uncertain Whether there will be an expansion of governmental activities in the making of loans to private enterprise depends in part on business conditions and in part on the economic philosophy of the political party in control of the government But whatever the business conditions and whatever the philosophy of the dominant party it seems reasonably certain that the government will continue to play some part in the direct extension of credit It is even more certain that it will continue to regulate the extension of credit by private institutions and in all probability this regulation will become much more effective and thorough

CHAPTER 17

THE FEDERAL RESERVE BANKING SYSTEM

State and National Banks

Between the destruction of the Second Bank of the United States by Andrew Jackson in 1836 and 1914 there was no real banking system in the United States From 1836 until 1863 all banking operations were carried on by individual state banks and from 1863 to 1914 by individual state and national banks In many instances the state banks performed their functions inadequately or in an unsound fashion Most of them were small and lacked sufficient resources their officials often had no knowledge of sound banking and engaged in practices injurious to the economic life of the country An example of such practices was the wild cat state bank note issues which only ceased when taxed out of existence by the federal government The weaknesses of the state banks were of course to a large extent due to their inadequate regulation by state authorities In many states little was done to regulate the minimum capital required of a bank the type of loans it could extend the amount of its note issue or much of anything connected with its operation

The federal act of 1863 establishing national banks was a considerable improvement over most of the state laws dealing with banking It set minimum capital requirements for banks according to the size of the city in which they were located and provided that a portion of profits should be set aside as surplus to give added strength to banks It established definite reserve requirements against deposits and specified the types of loans and investments national banks could make Each bank was required to deposit United States bonds with the United States Treasury to an amount not less than $30 000 nor less than one third of its paid in capital stock In return a bank could receive from the Comptroller of the Currency national bank notes up to 90% of the value of the bonds deposited by it provided this sum did not exceed the bank s capital stock The government assumed the obligation of redeeming these notes in case the issuing bank failed to do so In this way national bank notes were given a security lacking in the state bank note issues Close supervision over national banks was entrusted to the Comptroller of the Currency The banks were required to make monthly and quarterly statements of their condition to him, and under his supervision national bank examiners were empowered to inspect the banks whenever it was thought desirable The banks were also required to publish detailed quarterly statements in local newspapers

Weaknesses of the National Banking Organization

While the functioning of the national banks showed a great improvement over that of the state banks nevertheless there were certain serious weaknesses in their operation which became particularly apparent during periods of business stress and financial difficulties Among these defects were lack of any unity among banks the decentralized system of bank reserves inelasticity of credit inelasticity of currency inefficient clearance of checks

The National Banking Act established no banking system—it established no central bank that would give unity to the separate banks and that would have a controlling guiding and aiding effect on the separate banks Under this Act each bank was completely dependent on its own resources for loans and in time of need there was no method provided for any pooling of the strength of the various banks This lack of unity is well illustrated by the reserve requirements under the National Banking Act National banks in New York Chicago and St Louis designated as central reserve cities were required to keep in their own vaults a reserve of lawful money equal to 25% of their demand deposits Banks in some fifty other of the more important centers known as reserve cities were also required to keep a 25% reserve but one half of this could be on deposit in banks in the central reserve cities The reserve percentage of the other banks called country banks, was fixed at 15% three fifths of which could be on deposit in banks in the central reserve or reserve cities Since the banks in the larger cities paid interest on these deposit accounts the banks in the smaller localities tended to keep the maximum reserves permitted by law in the banks of the larger centers especially in those of New York City The New York banks in turn used these reserves in the main as a basis for their call loans to brokers

These rigid reserve requirements coupled with the absence of any means by which one bank could utilize the resources of any central bank proved a serious weakness and the concentration or pyramiding of reserves in New York proved dangerous In periods of financial strain banks outside New York needed more cash They called on the New York banks for their reserves and the New York banks called on brokers for repayment This led to a wild scramble to sell securities and a financial panic might be in the making

Inelasticity of credit also resulted from the rigid reserve requirements and from the lack of unified organization and control If banks had lent up to the limits set by their reserve requirements they could not extend additional credit on even the best of security This resulted in checking credit expansion when it might be needed in the best interests of the economic life of the country Nor was there any central authority to aid a needed expansion or contraction of credit through changing the discount

rate or engaging in open market operations Nor did the National Banking Act make any provision for an elastic currency—that is for a currency that would expand at the time of the year and during the years when business activity demanded more cash in circulation and would contract when there was less need for cash It will be remembered that the amount of the national bank notes depended on the amount of government bonds held by the banks and not on commercial paper arising out of business trans actions As a matter of fact there was a tendency for the federal govern ment to reduce its bonded indebtedness during times of business prosperity and thus to cause the volume of national bank notes to be reduced at the time when more currency was needed

Since there was no unified organization of the national banks there was no unified system for the clearance of checks among cities Smaller banks cleared through their correspondent banks in the larger cities but a check might wander from bank to bank for days before it was finally presented to the bank on which it was drawn This was both costly and inconvenient to all the banks concerned

Organization of the Federal Reserve System

The enactment in December 1913 of the law establishing the Federal Reserve Banking System resulted from agitation for improvements in our banking operations which developed after the panic of 1907 The main lines of the new system were developed by the National Monetary Com mission a committee representing both houses of Congress after this Commission had made an exhaustive study of the financial systems of the United States and of leading foreign countries

In most other countries one central bank heads the banking structure but in the United States the view prevailed that sectional interests differed too widely for one central bank to be established The United States was divided into twelve districts in each of which a Federal Reserve Bank was established These Banks were situated in Boston New York Phila delphia, Cleveland Richmond Atlanta Chicago St Louis Minneapolis Kansas City, Dallas and San Francisco Within each district branches of the Bank may be established All national banks were required to join the Federal Reserve Bank of their district state banks were permitted mem bership upon compliance with the provisions of the law concerning member banks Only some 40% of commercial banks belong to the system but the member banks possess about two thirds of the assets of all our commercial banks

The Federal Reserve Banks were established as bankers' banks and are owned by their member banks As bankers banks they transact business directly only with their member banks except for slight modification made by the banking legislation of the 1930s Each member bank is re quired to subscribe an amount equal to 6% of its own paid in capi

tal and surplus to the stock of the Federal Reserve Bank of its district Only half of this amount has been called for but the other 3% may be demanded at any time Dividends payable by the Federal Reserve Banks are limited to 6% Until 1933 any earnings above 6% were divided between a tax payable to the federal government and the surplus of the Federal Reserve Banks Since 1933 the excess earnings of the Federal Reserve Banks go to the surplus fund but the federal government has wide control over it

While the Federal Reserve Banks are privately owned their general control is vested in public officials At the head of the entire system is the Board of Governors of the Federal Reserve System This Board has seven members who are appointed by the President of the United States with the advice and consent of the Senate for terms of fourteen years The terms are staggered so that not more than one expires within a two year period and reappointment after a full term has been served is illegal The Board is suppo ed to represent the varied business and geographical interests of the country and not more than one member may be appointed from any Federal Reserve district The Board has general supervision over the Reserve Banks and attempts to coordinate their policies It establishes and enforces rules concerning the kinds of assets to be held by the Reserve Banks it enforces the reserve requirements of the system and may change those for member banks it approves and has a voice in determining the rediscount rates of the Reserve Banks it comprises a majority of the committee which determines the system s open market policies it oversees the issuance of federal reserve notes and it appoints three of the nine directors of each of the Federal Reserve Banks The varied functions assigned the Board of Governors thus assure federal officials a predominant place in determining the general policies and activities of the Reserve System

In addition to the three directors appointed by the Board of Governors each of the Federal Reserve Banks has six other directors elected by the member banks Three of these are bankers and three must be non bankers who are to represent the varied business interests of the district To prevent the election of these directors being dominated by the large banks the member banks of each district are divided into large middle size and small banks and each group chooses two of the six elected directors One of the appointees of the Board of Governors becomes chairman of the board of directors and federal reserve agent while the board of directors elects its own president The functions of the board of directors and of the executive officers are the same as those for any corporation—the determination of the policies and operations of the bank But these policies and operations must be in line with those set by the Board of Governors for the system

Two other of the system s administrative bodies must be mentioned—

the Open Market Committee and the Federal Advisory Council The Open Market Committee is made up of the seven members of the Board of Governors and five representatives of the Federal Reserve Banks who are chosen by the boards of directors of the twelve banks This Committee has complete control over the purchase and sale of securities in the open market by the Federal Reserve Banks The Advisory Council consists of one member chosen by the directors of each bank Periodically it meets with the Board of Governors and advises and makes suggestions to the Board concerning banking policy

Functions of Federal Reserve Banks

Contrary to the situation existing under the National Banking Act, none of the cash in the member banks vaults can serve to fulfill their legal reserve requirements Under the Federal Reserve Act member banks keep all of their required reserves on deposit in the Federal Reserve Banks of their district The cash in their own vaults is kept only to meet the day to day demand for cash made by customers The legal reserve requirements for the member banks depend upon the cities in which they are located Until 1937 member banks in the central reserve cities (New York and Chicago) were required to keep 13% reserves against their demand deposits with the Federal Reserve Bank of their district Member banks in the reserve cities some sixty important centers were required to maintain 10% reserves and country banks 7% reserves on deposit with the Federal Reserve Banks of their district On all time deposits a 3% reserve was required Revision of the banking legislation in the 1930s empowered the Board of Governors to increase the reserve requirements to not more than twice their existing levels Several experimental changes have been made and the present requirements for the three categories of banks are 22¾% 17½% and 12% Five per cent has been set as the required reserves against time deposits

Member banks get deposits in Federal Reserve Banks, thus fulfilling their reserve requirements, in the same way that individuals make deposits in member banks—either by putting in cash and cash items or by borrowing The process of borrowing from the Federal Reserve Banks will be discussed in the next section

The Federal Reserve Banks themselves are required to keep a 35% reserve in gold (now gold certificates) or lawful money against their demand deposits It will be seen therefore that the final reserves against deposits in member banks are reserves against reserves For example a country bank is required to keep a 12% reserve against its demand deposits on deposit with its Federal Reserve Bank The Federal Reserve Bank must keep a 35% reserve against this 12% reserve deposited with it This means that the ultimate reserve against the individual s deposit is 35% of 12% or 4 2% In other words $1 of the reserve of a Federal Reserve Bank

can serve as backing for nearly $25 of deposits in a country member bank The final reserve against deposits in reserve and central reserve cities is larger because such banks are required to keep a larger percentage of reserves against their demand deposits The centralization and concentration of reserves in the Federal Reserve Banks thus makes possible a wide expansion of credit and tends to give a needed elasticity to our credit structure

Elasticity of Credit

Under the Federal Reserve Banking system member banks are no longer limited in their extension of loans by the amount of cash reserves which they possess As has been shown, only deposits in the Federal Reserve Bank of their district can serve as the legal reserves of member banks but such deposits may arise either from cash deposits or from borrowing from the Reserve Bank Therefore even if a member bank has lent up to the full extent of its reserves it need not refuse further credit extension It can use the methods prescribed by the Federal Reserve Act to increase its deposits in the Reserve Bank by borrowing from it

One of the methods by which the Reserve Banks aid their member banks in replenishing their reserves is through rediscounting commercial paper (promissory notes and bills of exchange) which the member banks have discounted for their customers Let us say that a Manchester bank has extended loans to the limit set by its reserve requirements A good customer wishes to borrow $1 000 on a promissory note or bill of exchange based on a commercial transaction The bank may discount the paper and send it to the Federal Reserve Bank of Boston for rediscount In this rediscounting process the Reserve Bank extends credit to the Manchester bank to the amount of the note less the rediscount rate just as the Manchester bank has extended credit to its customer to the amount of the note less the discount rate And just as the customer in all probability received the credit in the form of a deposit in the Manchester bank so the credit arising from the rediscount is probably in the form of an addition to the deposit of the Manchester bank in the Federal Reserve Bank of Boston If the charge for rediscounting amounts to $5 the deposit of the Manchester bank will have been increased by $995 As was shown in the discussion of the expansibility of loans by an individual bank on the basis of added reserves the Manchester bank can now expand its loans by something like 10% in excess of its added $995 of reserves

All paper presented to the Reserve Banks for rediscount must be endorsed by the member bank and when such paper reaches maturity it is presented to the member bank for collection Payment is usually met by a subtraction from the member bank s deposit in the Reserve Bank which of course decreases such bank s reserves In turn the customer will probably pay the member bank by a check on his deposit with it the

deposits of the member bank are reduced and the need for reserves lessened

The Board of Governors of the Federal Reserve system declares what types of paper shall be eligible for rediscounting Normally eligible paper must arise out of actual agricultural industrial or commercial transactions In general, its maturity must not exceed three months but exceptions are made for bankers acceptances and agricultural paper Paper arising from investment or speculative transactions is not eligible for rediscount An exception however is made for paper arising from transactions in the securities of the federal government These restrictions on the types of paper that may be rediscounted are based on the desire of the Federal Reserve officials to keep most of the Reserve Banks assets in the form of short term self liquidating paper

The rate of rediscount is fixed every two weeks by each Reserve Bank This rate is subject to the approval of the Board of Governors and the Board itself may at times take the initiative in determining the rate The rates usually vary among the Reserve Banks and may vary markedly as business conditions change During rising price periods when business is very active and the volume of credit extension is large the rate will usually be relatively high This is both to protect the reserves of the Reserve Banks and to limit a dangerous rise in prices and an unhealthy business boom During periods of low prices and depressed business the rate is usually kept low The Reserve Banks have heavy excess reserves and they are anxious to put credit to work for the improvement of business conditions A more detailed discussion of manipulation of the rediscount rate to affect price levels and business conditions will be given in a following chapter

If the member banks do not wish to use the rediscounting facilities of the Federal Reserve system they may secure loans called advances from the Federal Reserve Banks upon the security of their own notes backed by eligible commercial paper or United States government securities as collateral Since 1932 the Reserve Banks have been permitted to make advances to member banks on their own promissory notes secured by satisfactory paper even though it does not conform to the normal eligibility requirements The rate of interest in such cases however must be a minimum of 0 5% higher than the highest rate otherwise charged by the Reserve Bank Naturally member banks do not avail themselves of this privilege if they possess eligible paper, but in times of emergency this exception to the normal procedure is very advantageous to the member banks

Since the Federal Reserve Banks were established as bankers banks for their member institutions the great bulk of their business has been with the member banks Nevertheless, under emergency conditions loans may be made to non member banks and since 1934 direct loans to non banking

industrial and commercial enterprises may be made under certain special conditions The volume of these exceptional loans has been small

It will be remembered that the Federal Reserve Banks are required to maintain a 35% reserve against their demand deposits However this is not an absolutely inflexible requirement that will prevent a further expansion of credit under all conditions A Federal Reserve Bank may temporarily fall below the 35% requirement by the payment of a penalty tax on the amount of its deficiency Furthermore one Federal Reserve Bank may borrow from another Reserve Bank If for example the Boston Bank s reserves were at the 35% minimum while the New York Bank had an excess of reserves the Boston Bank might replenish its reserves by borrowing from the New York Bank The effect of this provision has been to create a great nation wide pool of reserves a vastly different situation from that existing under the National Banking Act when reserves were scattered and each bank was dependent on its own resources

In addition to making the credit supply more elastic through rediscounts for and loans to member banks the Federal Reserve Banks also affect the supply of credit through their open market operations In fact the open market operations are likely to be the more effective influence for the initiative is taken by the Reserve Banks in the open market operations while the rediscounting and lending policies of the Reserve Banks can only be effective if the member banks desire to make use of such facilities

Under their open market operations the Federal Reserve Banks acting through the Open Market Committee described earlier may buy and sell certain specified types of securities principally bankers acceptances and obligations of the United States government from and to anyone If a Federal Reserve Bank buys securities in the open market, payment is made by a check drawn on the purchasing Bank This check will be deposited in a member bank and the member bank will send it to its Reserve Bank for collection In most cases this collection will take the form of an addition to the member bank s deposit in the Reserve Bank thus adding to its legal reserves This increase in its legal reserves in turn enhances the lending capacity of the member bank If a Federal Reserve Bank sells securities in the open market it will be paid by a check drawn on a member bank In most cases payment on the check will be met by a subtraction from the member bank s deposit in the Reserve Bank This decrease in its deposit reduces the reserves of the member bank and thus contracts its lending capacity

Rediscounting and lending by the Federal Reserve Banks and their open market operations supplement each other in the attempts of the Reserve Banks to expand or contract the supply of credit If it is desired to expand credit the Reserve Banks make their rediscounting and lending attractive by reducing the rate charged for such services At the same time

they will buy securities in the open market If it is desired to contract the supply of credit the Reserve Banks rediscounting and lending rates will be raised and securities will be sold in the open market The efficacy of these combined operations in affecting price and business changes will be discussed later

Elasticity of Currency

A desirable currency system should be elastic—that is it should be able to be expanded in those periods of the year and in those years when there is need for a greater volume of currency and to be contracted when the need is less For example during December there is always a need for more currency in hand to hand circulation to be used for Christmas shopping and in years of extremely active business more currency is needed than in dull years Prior to the establishment of the Federal Reserve Banking system there was not a single elastic element in our currency The Federal Reserve Banking Act attempted to remedy this situation by its provisions for the issuance of federal reserve notes

The federal reserve notes while based on the assets of the Federal Reserve Banks are lawful money and are obligations of the United States government They are supplied by the Bureau of Engraving and Printing just as is government money They are redeemable at the United States Treasury or at any Federal Reserve Bank The Treasury redeems them from a gold certificate fund which the Reserve Banks are required to maintain

The original Act required that the federal reserve notes should be secured by a minimum of 40% in gold The other 60% was permitted to be in the form of eligible commercial paper held by the issuing Reserve Banks During the depression of the 1930s there was a great scarcity of eligible commercial paper and the Federal Reserve Act was amended to permit the Reserve Banks to substitute United States bonds for commercial paper as security against their note issues During a great part of the history of the Reserve Banks they have held such an abundance of gold or gold certificates that the notes have been secured in the main by gold This situation and the amendment permitting the use of United States bonds as security have reduced the elasticity of the reserve notes for they have prevented the issuance of the notes from being based on paper representing actual business needs for currency The seemingly extraordinary conditions however made it appear advisable to vary from the intentions of the creators of the system

When commercial paper forms a part of the security against reserve notes, the amount of these notes in circulation tends to expand and contract in accordance with business needs As the customers of member banks increase their borrowing the member banks have more commercial paper in their portfolios The borrowers take most of the proceeds from

their loans in the form of bank deposits but at the same time increasing bank deposits usually result in the need for more cash Increased borrowing and increased deposits usually represent more active business and more active business requires more currency in circulation As the member banks require more cash to meet their customers demands they turn to the Federal Reserve Banks of their districts Through the same processes that they may use to replenish their deposit accounts with the Reserve Banks for the purpose of expanding credit they may replenish their supplies of currency The Reserve Banks may rediscount commercial paper presented by member banks or make loans to such banks on their promissory notes backed by commercial paper as collateral The member banks in this case however take the proceeds of the rediscounts or loans in the form of currency rather than in the form of added deposits

As the need for currency in circulation diminishes customers pay it into their accounts at member banks The member banks finding themselves with a redundancy of cash pay back the notes to the Federal Reserve Banks In addition to this automatic process there are certain legal provisions that aid in providing for the contraction in the volume of federal reserve notes Neither a Federal Reserve Bank nor a member bank may count federal reserve notes as a part of their legal reserves nor may one Federal Reserve Bank put back into circulation the notes of any other Reserve Bank which it may hold without the payment of a penalty tax Each Reserve Bank must return to the other Reserve Banks notes issued by them The issuing Bank can then either pay them out again or retire them from circulation

Clearance of Checks

Since some 90% of all business transactions in the United States are financed by checks drawn on demand deposits an efficient mechanism for the clearance of checks is highly desirable The methods of clearing checks when both the drawer and payee have accounts in the same bank or if the accounts are in different banks but in the same city have already been described But frequently the accounts of the drawer and payee may be in banks located in widely separated cities For example a student in Hanover New Hampshire may receive a check from his father drawn on a bank in Evanston Illinois The student deposits the check to his account in the Hanover bank How does the Hanover bank secure collection from the Evanston bank?

The great bulk of such collections are now carried on through the Federal Reserve Banking system Let us first assume that the banks of the drawer and of the payee of the check are in the same Federal Reserve district The bank in which the check is cashed or deposited will send it to the Federal Reserve Bank of the district The Reserve Bank will forward it to the bank on which it was drawn If this bank does not protest the

check within a short period the amount of the check will be credited to the receiving bank and debited to the bank on which it was drawn Thus by simple bookkeeping transactions at the Reserve Bank intra district clearings are accomplished

Naturally the process of clearing checks when the banks concerned are in different Federal Reserve districts, our Hanover Evanston illustration is somewhat more involved The Hanover bank will send the check to the Federal Reserve Bank of Boston which will send it to the Federal Reserve Bank of Chicago The latter will now present it to the Evanston bank on which it was drawn If the Evanston bank makes no protest the check will be debited to its account with the Chicago Reserve Bank and credited to the Hanover bank s account with the Boston Reserve Bank The final step is to clear the account between the Boston and Chicago Reserve Banks For this purpose a so called gold settlement fund is l ept in Washington to which each of the Reserve Banks subscribed and which is administered by the Board of Governors of the Federal Reserve system Each day the Reserve Banks wire the Board of Governors the amount of their claims against the other Reserve Banks Clearance of the claims is made by debit and credit transactions involving the relative ownership of the gold settlement fund by each of the Reserve Banks If for example, the claims of the Boston Bank against the Chicago Bank exceed those of the Chicago Bank against the Boston Bank, the equity of the Boston Bank in the fund gains at the expense of that of the Chicago Bank

Most non member banks participate in the check clearance operations of the Federal Reserve system To do so such banks must maintain deposits with the Federal Reserve Banks and must agree to the par payment of checks—that is to pay without any fee all checks drawn upon them Par payment is likewise required of all member banks

As Fiscal Agents for the United States Government

The Reserve Banks carry on banking operations for the federal government in somewhat similar fashion to the functions performed by ordinary banks for their customers The Reserve Banks hold government deposits carry on a checking account business with the government and transfer government funds from one section of the country to another The Reserve Banks also play an important part in the flotation of government securities Such securities are frequently issued through the Reserve Banks the latter receiving subscriptions for them The Reserve Banks serve as agents in paying interest on the securities and in paying them off at maturity Cooperation between the Reserve Banks and the United States Treasury is so close that at times it is alleged that the Banks dominate Treasury policy More frequent in recent years is the allegation that the domination comes from the Treasury, and that political influences too greatly affect the policies of the Banks

Statements of the Federal Reserve Banks

The statements of the Federal Reserve Banks give a good picture of their functioning These statements are published each Friday in the metropolitan newspapers and it would be well for the student to notice changes in their various items at different periods as these changes show the varying importance of the functions performed by the Banks The following statement shows the condition of the twelve Banks combined as of July 3 1940 and as of the similar date a year earlier It also shows the condition of each of the Banks which indicates the relative amount of business done in the several Reserve districts

It is very interesting to note in the above combined statement the extremely large gold certificate holdings of the Reserve Banks and the large increase in these holdings between July 1939 and July 1940 This increase was due in the main to the large inflow of gold from abroad to meet unfavorable trade balances of foreign countries and also to seek shelter from the disturbances created by war It is also important to notice the very small holdings of discounted bills and the absence of bills bought in the open market This shows that the member banks were making little use of the rediscounting facilities of the Reserve Banks and that the Reserve Banks were not attempting on their own initiative to expand credit through open market operations A look at the item *member bank deposits* will show the reason for the small volume of discounted bills and the absence of bills bought in the open market These deposits representing the reserves of the member banks were extremely large and had increased over $3 500 000 000 in a year s time There was therefore no reason for most member banks to use the rediscounting facilities of the system nor for the Reserve Banks to buy securities in the open market Under such conditions the largest assets of the Reserve Banks except for their gold certificate holdings were various types of United States government securities Their large gold certificate holdings gave the Reserve Banks the very high rate of 88 9 per cent reserves against their demand deposits and reserve note liabilities When it is remembered that the Reserve Banks are only required to maintain a 35 per cent reserve against deposits and a 40 per cent reserve against notes, the tremendous possibilities of credit and note expansion become apparent

Accomplishments of the Federal Reserve System

During most of the life of the Federal Reserve system it has been confronted with what formerly at least would have been called abnormal or even emergency conditions Soon after the enactment of the Federal Reserve Act the World War of 1914 1918 began and before the new system was well established it was called on to play a major part in financing our war time activities During the early 1920s there were the problems

TWELVE FEDERAL RESERVE BANKS COMBINED

ASSETS	*July* 3 1940	*July* 5 1939
Gold certificates on hand and due from United States Treasury	$17 840 475 000	$13 534 719 000
Redemption fund—Federal Reserve notes	10 862 000	8 412 000
Other cash	338 248 000	317 756 000
Total reserves	$18 189 585 000	$13 860 887 000
Bills discounted		
Secured by United States Government obligations direct and guaranteed	711 000	940 000
Other bills discounted	1 437 000	3 698 000
Total bills discounted	$2 148 000	$4 638 000
Bills bought in open market		556 000
Industrial advances	9 186 000	12 318 000
United States Government securities direct and guaranteed		
Bonds	1 323 196 000	911 090 000
Notes	1 126 732 000	1 176 109 000
Bills		463 438 000
Total United States Government securities direct and guaranteed	$2 449 928 000	$2 550 637 000
Total bills and securities	$2 461 262 000	$2 568 149 000
Due from foreign banks	47 000	167 0 0
Federal Reserve notes of other banks	20 227 000	20 218 000
Uncollected items	721 440 000	590 799 000
Bank premises	41 436 000	42 356 000
Other assets	54 450 000	47 377 000
Total assets	$21 488 447 000	$17 129 953 000
LIABILITIES		
Federal Reserve notes in actual circulation	$5 247 837 000	$4 543 177 000
Deposits		
Member bank—Reserve account	13 736 629 000	10 151 053 000
United States Treasurer—General account	221 447 000	820 208 000
Foreign bank	753 332 000	297 265 000
Other deposits	492 022 000	380 299 000
Total deposits	$15 203 430 000	$11 648 825 000
Deferred availability items	679 476 000	590 412 000
Other liabilities including accrued dividends	1 373 000	2 181 000
Total liabilities	$21 132 116 000	$16 784 595 000
CAPITAL ACCOUNTS		
Capital paid in	$137 194 000	$135 053 000
Surplus (Section 7)	151 720 000	149 152 000
Surplus (Section 13b)	26 839 000	27 264 000
Other capital accounts	40 578 000	33 889 000
Total liabilities and capital accounts	$21 488 447 000	$17 129 953 000
Ratio of total reserves to deposit and Federal Reserve note liabilities combined	88 9%	85 6%
Commitments to make industrial advances	$8 700 000	$10 958 000

INDIVIDUAL RESERVE BANKS

CONDITION AT CLOSE OF BUSINESS JULY 3 1940

District	*Total Reserve*	*Total Bills Discounted*	*Total U S Govt Secur*	*F R Notes in Circulat n*	*Due Members' Reserve Acct*
Boston	$1 062 355 000	$149 000	$178 703 000	$ 430 139 000	$ 729 677 000
New York	8 978 137 000	402 000	751 101 000	1 406 195 000	7 526 568 000
Philadelphia	951,421 000	83 000	194,432 000	362 144 000	662 809 000
Cleveland	1 174 296 000	131 000	251 246 000	471 925 000	843 310 000
Richmond	475 914 000	110 000	122 623 000	229 791 000	317 568 000
Atlanta	355 956 000	164 000	89 844 000	168 247 000	227 109 000
Chicago	2 800 452 000	91 000	259 948 000	1 138 333 000	1 757 650 000
St Louis	445 587 000	100 000	113 363 000	197 079 000	313 999 000
Minneapolis	267 837 000	128 000	72 080 000	144 586 000	155 004 000
Kansas City	380 183 000	376 0 o	115 722 000	190 528 000	266 937 000
Dallas	258 528 000	336 000	95 464 000	81 892 000	225 870 000
San Francisco	1 038 919 000	78 000	205 402 000	426 978 000	710 128 000

connected with readjustment to a peace time economy Then in 1929 came the great depression which has continued to a greater or less extent up to the present In the later years of this period the situation was complicated by war or threats of war in various sections of the world the culmination being the outbreak of the new European War in 1939 It is not strange that under such conditions the Federal Reserve Banking system has not been as successful in its accomplishments as had been hoped for More over added to the above difficulties was the existence of non member state banks constituting the majority of American banking institutions over whose operations control by the Federal Reserve Banks was very remote

The Federal Reserve system has provided a better method for maintain ing bank reserves It has increased the elasticity of currency and credit And it has vastly improved the system of check clearance It has not suc ceeded in stabilizing prices and business conditions as the great depression of the 1930s amply demonstrated In fact as a result of this depression our banking system temporarily broke down in March 1933 when for a number of days every bank in the country was closed The factors in volved in this debacle are too varied to be assessed here for all the causes giving rise to the swings of the business cycle would have to be reviewed To blame this great depression on mistaken policies of the Federal Re serve system is too simple an explanation although undoubtedly some of our monetary and banking policies were unwise and played their part in bringing on the depression It is also unfair to say that the Federal Re serve system should have been able to prevent the crash of 1929 for it is questionable if any banking system as such could have done so

As a result of the banking collapse of 1933 rather wide changes were made in the Federal Reserve Banking Act The banking legislation of the 1930s to some extent changed the general philosophy of the Reserve sys tem No longer is the emphasis on banking decentralization with each of the twelve Banks largely responsible for its own policies and activities

The principle embodied in the new legislation is that responsibility for a national banking policy should be centered in the Board of Governors of the Federal Reserve system To carry out this principle the Board has been given much greater authority over reserve requirements discount rates open market operations the purpo es for which bank credit can be used and other matters connected with banking policy and practice In addition as was described in the preceding chapter a federal system of insurance for bank deposits was established

Another important development of the 1930s has been the great increase in control over monetary and banking matters exercised by the United States Treasury The devaluation of the dollar through raising the price of gold and the existing power to raise the price still more the Silver Pur chase Act the operation of the Foreign Exchange Stabilization Fund (to be discussed later) and tremendous borrowing by the government have given the Treasury equal if not greater control over monetary and banking policies and practices than has the Reserve system Time alone can tell whether Treasury control will continue to grow until for good or ill there has been an almost complete nationalization of banking operations if not of bank ownership

CHAPTER 18

THE VALUE OF MONEY OR THE GENERAL PRICE LEVEL

Meaning of the Value of Money

The value of money means its general purchasing power—that is, how much goods and services in general a certain unit of money commands Everyone knows that prices in general vary sometimes rising, sometimes falling But it is frequently assumed that these price changes are always due to changes in the supply of goods The statement that a dollar is always a dollar is occasionally heard There was a degree of truth in this statement during the many years that a dollar could be defined as 23 22 grains of fine gold Since the price of the gold contained in the dollar was set by law the price of the gold contained in a dollar did not fluctuate as market conditions changed But there was never any truth in the statement if it was intended to mean that the purchasing power of the dollar never changed Even in countries on a full gold standard while the price of gold remained fixed nevertheless the exchange value of gold and of the monetary unit based on gold in terms of other commodities and services did vary The value of money or its purchasing power varies inversely with the general price level As the price level rises the value of money becomes less as the price level falls the value of money becomes greater

Naturally the prices of all goods and services do not change in equal proportion in a given interval of time In fact during a period when most commodities are rising in price some may be falling and vice versa Therefore in order to secure a reasonably accurate measurement of changes in the general price level index numbers of various types are used

Index Numbers

An index number of prices is a statistical device for measuring the average of the price movements of groups of commodities and services over a period of time If the actual prices of several hundred commodities over a period of years were placed before one the figures would be so complicated that it would be difficult to draw a conclusion from them If instead the prices of a certain year are used as a base and to the prices of that year the percentage figure 100 is assigned price variations in other years can easily be placed in reference to those of the base year and the determination of changes in the price level arrived at

The following easy illustration shows the method of constructing the simplest type of index number of prices—the arithmetic average type The prices are assumed and 1926 is taken as the base year

	Wheat Price	*Index Number*	*Cotton Price*	*Index Number*	*Sugar Price*	*Index Number*	*Composite Index Number*
1926	$1 00	100	15	100	06	100	100
1929	1 25	125	15	100	07	113	113
1932	50	50	06	40	05	87	59
1940	80	80	09	60	06	100	80

Since 1926 is taken as the base year the prices assumed for these commodities in that year are represented by the figure 100 in the index number column The index numbers for the succeeding years depend upon the percentage relationships of the prices of the several commodities in those years to their prices in the base year For example the price of cotton in 1932 is assumed to be 6 cents a pound Six cents is 40% of 15 cents the price assumed for 1926 Therefore, the index number for cotton in 1932 is 40 The composite index figure which shows the general price level is derived in this type of index number by averaging the index figures of all the commodities for a particular year

The prices of all commodities however are not equally important in showing general price level trends Money spent for tea for example does not constitute as large a proportion of the housekeeper s expenditures as does money spent for bread To make allowance for the unequal importance of expenditures for different types of goods the weighted arithmetical average type of index number is often used Reverting to our previous illustration let us assume that wheat bulks three times as large as sugar in our general expenditures and cotton twice as large as sugar In constructing a weighted index number the weight of 3 would be given to wheat 2 to cotton and 1 to sugar To secure the composite index number for any year the index number for wheat would be multiplied by 3 that for cotton by 2 and for sugar by 1 and the added total divided by 6 The operation for 1929 would be

$$\frac{3 \times 125 + 2 \times 100 + 1 \times 113}{6} = 115$$

The weighted composite index numbers for the four years given in the previous illustration would be

1926	100
1929	115
1932	53
1940	77

By comparing the unweighted and the weighted composite index numbers for the four years, it will be seen that while the two sets of numbers

show the same trend in the price level they also show a difference in degree in the trend This is because heavier weighting has been given to the commodities whose assumed prices fluctuated the most

In addition to the above types of index numbers various others such as the median the mode and the geometric mean are used It is not worth while to give illustrations of these other types but it is necessary for the student in examining index figures to understand what type is being used If there is a pronounced trend in changes in the general price level all types of index figures will show the same trend They may at times how ever show a considerable difference in the degree of the trend

Many organizations in the United States study and make reports con cerning price level changes The best known of these are the reports on the wholesale price index made by the United States Bureau of Labor Statistics These reports are based on the wholesale prices of 784 com modities which are weighted according to amounts sold Complete as these reports are in regard to wholesale prices of commodities they do not take into consideration other factors affecting the general price level such as real estate values security prices and transportation costs The attempt has been made to combine all these items into a general price index by Mr Carl Snyder formerly of the Federal Reserve Bank of New York He has divided the various prices into twelve groups has given each a certain weight and then has arrived at a composite index number

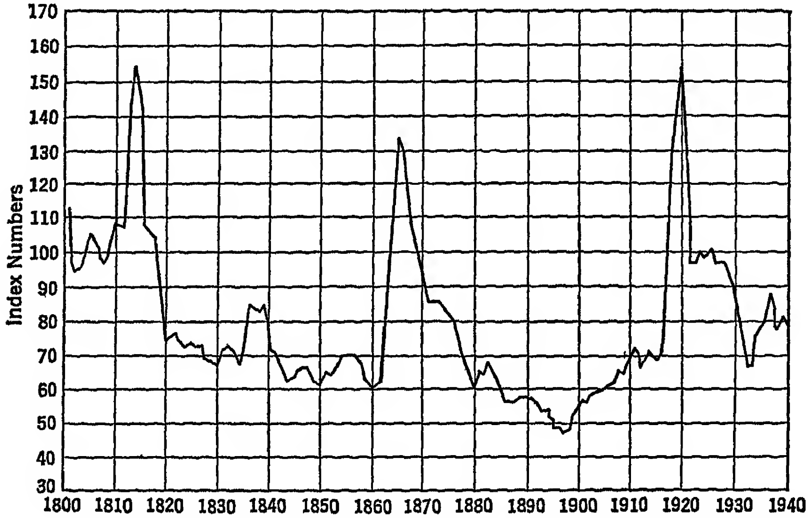
Price Level Changes in the United States

The graphic presentation on page 282 shows the changes in wholesale prices in the United States from 1801 to 1940 as presented by the United States Bureau of Labor Statistics [1]

It will be noticed that the three great peaks in prices coincided with the War of 1812 the Civil War and the World War of 1914 1918 The price level moved upward until 1814 After reaching a peak in that war year it moved downward until 1849 It then turned slowly upward until the new trend was made most emphatic during the Civil War After the Civil War there was a downward trend for more than 30 years the bottom being reached in 1897 After that year prices moved rather sharply up ward until 1914 when they skyrocketed to the level of 1920 the highest point yet reached in the United States In 1921 a precipitous drop oc curred and during most of the twenties prices remained fairly stable at the new lower level The depression of 1929 caused a new sharp drop in the price level until the depression low was reached in 1932 Beginning in

[1] The chart from 1801 to 1934 was prepared by Nathan L Silverstein Department of Economics University of Wisconsin and appears in W H Kiekhofer *Economic Principles Problems and Policies* (D Appleton Century Company Inc New York 1936) p 600 The data from 1934 to 1940 were prepared by the present writer The data from 1801 to 1931 were taken from Bulletin 572 p 14 of the United States Bureau of Labor Statistics The later data were taken from the Bureau s monthly bulletin on *Wholesale Prices*

1933 a rise again occurred, continuing until 1937 In 1937 another drop took place and during 1938 1939 and up to the present in 1940 the index figure with the prices of 1926 representing 100 has varied between 77 and 79



Different Types of Price Level Movements

Types of price changes may be divided into secular cyclical irregular and seasonal For the purposes of our present discussion seasonal changes, those which occur at different periods of the year, may be disregarded The prices of many goods fluctuate widely during the months of the year, some being higher at certain times of the year and others at other times But these fluctuations do not greatly affect the general price level or the value of money the topic in which we are interested in this chapter

Secular price changes are those which show an upward or downward trend over a long period of years For example as is shown by the price movement chart for the United States from 1814 until the 1840s the secular trend was downward The upward trend beginning in the 40s was exaggerated by the abnormal Civil War conditions After the Civil War there was a long downward trend which lasted until 1897 when an upward secular trend set in which continued until 1920 Since 1920 the general trend has been downward

Within each of the secular trends there are shorter run cyclical trends of prices These can be observed on the chart which, for example, while showing that from 1865 until 1897 the general trend of prices was downward also shows upward and downward oscillations within the general downward movement These shorter oscillations depict the higher prices of the prosperity phase of the business cycle and the lower prices of the depression phase During periods when the secular trend of prices is up

ward the prosperity phase of the business cycle tends to be longer and the depression phase shorter The opposite is true when the secular trend of prices is downward

Irregular price movements have no regularity of occurrence and cannot be considered as a definite part of secular and cyclical trends although they may greatly affect such trends These irregular movements are most often due to war Illustrations of such movements are shown graphically by the great peaks to which prices rose during the War of 1812 the Civil War and the World War of 1914 1918

Effects of Changes in the Price Level

If all the prices changed in the same direction and to the same degree within a certain period such changes would make little if any difference in the economic life of the country All producers and all receivers of income would be in the same relative position that they were before the change in the price level occurred The only difference would be that every supplier of any kind of good or service would receive a certain per cent increase or decrease in his monetary income but he would also pay the same per cent increase or decrease for the things he bought with his income Since the goods and services supplied by each would still command the same amount of other goods and services the position of each would be the same as before

It is not true however that during periods of price changes all prices change in equal proportions When prices in general are rising a few prices actually may be falling More important there is usually a wide variation in the degree in which the various prices fluctuate This lack of uniformity in price changes has been increased by the greater tendency toward sticky prices in many lines of production which was discussed in a previous chapter

A rapid change in the price level has a revolutionary effect on the economic value of established claims to wealth and income Such an effect is hidden and is not so clearly seen as if the established claims had been destroyed by drastic legislation or violent revolution but at times the effect of a change in the value of money is just as great as is that resulting from confiscatory legislation or from revolution

Changes in the price level are especially important in their effect on the creditor debtor relationship Naturally the longer the term of the contract between the debtor and creditor the greater will the effect of a change in the price level on their relative positions tend to be Let us assume that a corporation sells $10 000 000 of its bonds payable in 20 years Within that period the price level rises to a point twice as high as when the bonds were issued The value of the claims of the bondholders against the corporation while remaining the same in dollars actually becomes only one half as great in purchasing power The stockholders equity in

the corporation has risen at the expense of the bondholders If the price level had fallen the opposite would have been true The value of the claims of the bondholders would have been enhanced that of the stockholders would have fallen This latter statement is true however only if the corporation remains solvent In periods of rapidly falling prices there are many more business failures than during periods of rising prices The position of depositors in savings banks and of holders of life insurance policies is the same as that of bondholders If the price level rises the value of their savings becomes less Those who have borrowed the savings usually business organizations gain at the expense of the savers If the price level falls the savings bank depositors and insurance policy holders gain—provided the banks and insurance companies remain able to meet their obligations

The above discussion shows that those individuals and groups whose incomes are relatively fixed lose during periods of rising prices and gain during periods of falling prices if prices do not fall too disastrously Those whose incomes vary more especially the active business classes tend to gain during rising prices and to lose during falling prices During rising price periods the money income from the sale of their goods increases their expenses do not rise proportionally for many of their costs like interest on bonds remain the same and others like wages do not rise rapidly During falling price periods the situation is reversed The monetary returns to business enterprise fall some costs remain fixed and there is a lag in the drop of others Lessened profit or even actual loss results

This difference in the position of the active business classes and the groups on fixed incomes was well illustrated during the World War of 1914 1918 Prices soared and most of the active business classes reaped enormous gains Organizations like colleges and universities for example whose incomes were largely fixed found their positions difficult and consequently so did their employees This led to drives to increase the resources of the educational institutions and in at least one university the laudable if undignified slogan Feed our Profs! was sounded

Wages in general tend to lag during a changing price level This is more true for skilled and white collar labor than for unskilled workers Wages for the skilled and white collar groups are more likely to be fixed by contract or at least there is a more customary wage for them than for the unskilled During periods of rising prices the employer does not usually raise wages until forced to do so by labor unions or by the added competition for laborers During falling prices he at first hesitates to disrupt his organization and is particularly loath to cause dissatisfaction among his skilled workers by cutting wages A lag in the fall of wage rates therefore occurs But this lag will probably be accompanied by less employment Unskilled workers are likely to be discharged the skilled may find themselves on part time The final result is that the position of laborers in

general tends to be better during periods of gradually rising prices than during periods of rapidly falling prices There is a lag in wage increases but employment is more secure

Changes in the price level have a tremendous effect on production In an economy like ours production depends upon the prospect for profits In periods of rising prices profits tend to expand for as has been shown the costs of entrepreneurs do not rise as fast as their sales prices and business activity is greater During falling prices the margin between costs and sales prices contracts and profits decline While this analysis is in the main true certain developments in the modern economy such as price administered by private business or by government have made it less accurate The relatively inflexible prices fixed by governmental agencies for the utilities injure these industries during rising price periods for their income does not rise proportionately to their costs During falling prices their profits tend to be larger if consumers continue their purchases at the unchanged rates The effects of the sticky prices administered by private business are felt especially during periods of falling prices As has been shown earlier such policies either increase unemployment in the industries adopting them or cause a shift in the general purchasing power toward these industries and away from industries like farming which have little or no control over their prices

It would be incorrect to assume that changes in the price level are the sole cause of the fluctuations in business known as the business cycle Violent price changes result from as well as tend to increase the swings of the cycle For example among the many causes advanced in explanation of the depression of 1929 are the great agricultural surpluses war debts and reparations the large volume of post war foreign lending and its sudden cessation the maldistribution of gold among the various countries the return to the gold standard by different countries at wrong foreign exchange parities unsound investments the speculative inflation of the American stock market [2] After the depression began the decline in prices made the debacle more complete Weak debtors were squeezed and there was a forced sale of all types of goods This severe liquidation brought such a great strain on the whole business and financial structure that its effects are still being felt

While it is very true that changing price levels are at least aggravating causes of cyclical swings it is also true that at times relatively stable prices may have similar effects There are some who believe that the relative stability of prices between 1922 and 1929 had a part in bringing on the depression of 1929 Prices remained relatively stable while productive efficiency was increasing Since unit cost of production decreased while selling prices remained stationary, profit margins increased This it is

[2] F B Garver and A H Harper *Principles of Economics* (Ginn and Company Boston) pp 344 345

held tended to cause an overexpansion of productive equipment in many lines which was contributory to the difficulties of 1929

The economic fluctuations which are in part caused by severe price changes frequently produce social and political unrest Both rising and falling prices are often accompanied by serious labor disputes When prices are rising laborers find that the purchasing power of their wages is falling To protect their standard of living demands are made on employers for higher wage rates If these demands are not granted strikes frequently ensue When prices are falling workers are faced with both wage cuts and unemployment In such periods strikes are not such effective means for protecting labor standards as during rising prices for employers are making less gains and frequently care little if there is a plant shutdown More radical movements for altering the whole economic structure are therefore likely to make headway among the laboring groups

In the United States toward the end of the long period of falling prices from 1865 to 1897 the Populist movement developed especially among the farmers It favored such steps at that time considered radical as increased governmental ownership and regulation of industry But it also recognized that the plight of farmers and laborers was in part due to falling prices by its support of the issuance of additional greenbacks and by supporting Bryan in the Free Silver Campaign In this campaign of 1896 there was a rather definite alignment of conservative interests who wanted to maintain a ' sound money against the indebted farmers and other groups who wanted a cheaper money

The falling price and depression period of the 1930s also produced social and political unrest There were bitter strikes in many industries and communism took foothold among workers to an undetermined degree Farmers exhibited their protests in such acts of violence as destroying milk on the way to market and as forcibly preventing the sale of property for the payment of mortgages or taxes Among the impoverished groups the panaceas proposed by Huey Long Father Coughlin, and Dr Townsend were supported by many That there was not a greater degree of unrest and a greater acceptance of radical philosophies during this period was undoubtedly due to the additional responsibilities assumed by the United States government To a greater degree than ever before the government made efforts to halt the declining price level and at the same time to provide work for those who were unemployed due to the downward cyclical swing

While in the United States the chief periods of unrest have been during falling prices nevertheless rapidly rising prices can produce the same result A classic example of this was in Germany in the early 1920s The reckless issue of printing press money made it possible to calculate the prices of even the simplest commodities only in terms of billions of marks The result was that those with fixed incomes especially those whose incomes came from interest on savings accounts and from bonds lost prac

tically all of their purchasing power The bondholders and those with savings accounts lost not only their income but also their principal Sup pose for example that in 1914 a German citizen owned bonds issued by a German corporation with a face value of 100 000 marks This was equal to $25 000 After the orgy of inflation these bonds were worth less than one cent The stockholders of the corporation of course made tremendous gains through the process, for the corporation s fixed debts could be paid off in valueless currency The heaviest blow of this inflation fell on the supposedly stable solid middle class With their life time savings gone they fell into despair and were ripe for the demagoguery of Hitler and the other Nazis To an appreciable extent the early strength of Hitler was based on support by the middle class whom inflation had dispossessed

Causes of Changes in the General Price Level

The equation of exchange $MV + M V = PT$ shows the relationship among money goods and prices In this equation M stands for the total quantity of money both specie and paper in circulation It must be noted that it is the amount in actual circulation that which is being hoarded or is otherwise unused is not included V represents the velocity of the money in circulation that is the average number of times each unit is exchanged for goods and services during a certain period M is the average volume of demand deposits in banks It has been shown earlier that in the United States something like 90% of all payments are made by means of checks drawn against bank deposits V stands for the velocity of circulation of bank deposits—the average number of times that a unit of deposits is exchanged for goods and services during a particular period P denotes the average price paid for all goods and services during a period T represents the total volume of trade—the total quantity of all types of goods and services exchanged for money within the period It will be seen of course that the greater the number of times a good is exchanged before it reaches the final consumer the greater will the item T be in the equation That is eggs sold directly from the farmer to the consumer will not expand T to the same extent as if the eggs passed through the hands of several middlemen before reaching the consumer

The equation of exchange of course does not *explain* a particular price level nor price changes It is simply a mathematical statement of rela tionships It merely shows that the amount of money in circulation multi plied by its velocity plus the amount of bank deposits multiplied by their velocity equals the average price per unit multiplied by all goods and services being exchanged for money Since it is the price level in which we are interested it is well to transpose the equation so that it will stand $P = \frac{MV + M V}{T}$ In this form the relationship between the price

level and the other items in the equation can as a consequence, be seen more clearly

To understand the various factors affecting the price level it will be well to take up various possible changes in these factors and to show the results of such changes

Anything which increases the amount of money in circulation naturally tends to raise the price level, just as conversely anything decreasing the volume of money will tend to lower the price level For countries on a real gold standard the chief factor affecting the size of M is the production of gold It is true that paper money may also be in circulation, but if a country is on a real gold standard it must limit the issue of paper money to an amount that can be redeemed in gold The effect of gold production on the price level can be shown historically The falling price level be tween 1814 and 1849 came to an end coincidentally with the opening of the California gold fields From the 1870s until the 1890s gold production decreased and this was a period of falling prices In the late nineties great gold discoveries were made in Alaska and South Africa and during the same period the cyanide process of refining gold was introduced A rising price period got under way in the late nineties and continued until 1920 If a country is on a paper standard the price level is affected in a similar fashion by the volume of M but in this case the volume is deter mined by the amount of paper money the government decides to issue rather than by gold discoveries or new processes in its mining The illustration of Germany in the early 1920s shows that prices rose as the amount of paper money increased

V or the rate of velocity at which the money in circulation is ex changed for goods, plays an important part in determining P the price level The spending of $1 000 ten times each year will have the same effect on P as will $10 000 spent only once a year V is largely dependent on the monetary habits of the people concerned—whether or not they are in the habit of holding money a considerable length of time before spending it Such customs depend to a large extent on whether a com munity is mainly agricultural or industrial on the concentration of popu lation and the ease of access to markets The more highly industrial sections are likely to have a greater velocity of money These habits are modified somewhat in the different periods of business activity In periods of great business activity V tends to increase a slowing up of business tends to decrease V Again any loss of confidence in a country s money will cause a rapid increase in its velocity People will want to exchange it for goods before it has a further loss in purchasing power For example in Germany between 1919 and 1923 the currency in circulation increased about a thousandfold while the price index increased 54 000 times It is estimated that during this period the velocity of money expanded fifty fold The almost hourly fall in the value of money caused people to spend

it as soon as it came into their possession and this in turn caused the value of the mark to fall still more

M the amount of bank deposits subject to checks depends on the monetary and banking habits of a people on the nature and quantity of the money used for reserves against bank deposits on the percentage of reserves maintained by the banks and on the period of the business cycle It has not been the habit of continental Europeans to use checks drawn on bank deposits in payment of business transactions to anything like the extent that they are used in England Canada or the United States Therefore M bulks much larger in the equation of exchange in these latter countries than on the European continent If gold in one form or another constitutes the reserves against bank deposits M will depend on the amount of gold held by the banks of a country The great inflow of gold to the United States in recent years has given our banks a plethora of reserves now in the form of gold certificates On the basis of their present holdings our banks could expand their deposits enormously The extent to which bank deposits can be expanded also depends upon the reserve requirements of the banking system The concentration of re serves provided for in the Federal Reserve Banking Act made for a much greater expansion on the basis of a given amount of gold holdings than had been possible previously Almost immediately use was made of this greater expansibility when a large proportion of the sale of Liberty Bonds in 1917 1919 was financed through Federal Reserve Bank credit and M increased greatly In the past few years the great increase in reserves held by American banks has aroused fear of such an enormous increase in M that there would be an inflationary rise in prices As a preventive the Board of Governors of the Federal Reserve system has rather radically increased the reserve percentage requirements of member banks Despite this increase most member banks and the Reserve Banks still maintain a large volume of excess reserves The relatively small bank deposits in relation to the volume of bank reserves is due to the relatively small amount of credit which customers have obtained from banks It will be remembered that a very large proportion of bank deposits arises from bank created credit Business men have found the prospects for profits rather gloomy This has prevented them from expanding production and therefore their demand for bank credit has been small M always tends to decrease during periods of business inactivity or depression On the other hand when business is very active enterprises need more funds They turn to the banks for credit and M increases

The previous discussion of the factors affecting V the velocity of money in large measure applies to V the velocity of bank deposits The nature of the economic life of the country the banking habits and the period of the business cycle all play their part in determining the magni tude of V In so far as farmers maintain bank deposits they are not

likely to have such a rapid turnover as are those of urban business men In countries where a large proportion of business obligations are settled by means of bank checks V has a more important influence on the price level than in countries where there is not such an extensive use of checking accounts During periods of great business activity V tends to increase at a more rapid rate than M and in the opposite phase of the cycle V shrinks more rapidly than M For example in the United States between 1930 and 1933 M decreased about 30% but V dropped some 50% All the factors tending to increase V tend to increase the price level, and all those operating to reduce V tend to lower the price level

The volume of T depends upon both the total quantity of goods and services of all sorts available for exchange and upon the number of times each unit is sold within a particular period If the volume of goods and services offered for sale increases the tendency is for the price level to fall If this volume decreases there is the opposite tendency for the price level to rise In an industrially developing country like the United States there is usually an upward trend in T There are vast resources to be developed and more efficient productive technique is constantly being introduced Specialization as a part of this technique increases T in two ways it increases the total volume of production and at the same time it causes goods to be exchanged more times before they reach the final consumer While the long run tendency in the United States has been for T to increase, the fluctuations of the business cycle have caused great irregularity in the increase In periods of prosperity there is a great expansion in the production of goods and services Depression brings with it a great slowing up of their output In the various phases of the cycle however there is an appreciable lag in changes in the volume of goods offered for sale and in the amount of money and bank deposits offered for them In prosperous periods T usually expands less rapidly than money and bank deposits and their turnover and prices tend to rise In the downward phase of the cycle T usually contracts at a less rapid rate than money and bank deposits and their turnover, and prices tend to fall

The Quantity Theory of Money

While the equation of exchange merely shows the relations among the factors affecting the price level nevertheless it is used by those propounding the quantity theory of money to show that the sole forces, or at least the outstanding forces affecting the price level are those on the left hand side of the equation $MV + M\,V = PT$ In its simplest form the quantity theory of money is that the value of money in any country tends to vary inversely as the quantity of money in that country varies Or to state it another way changes in the quantity of money are the underlying causes of changes in the price level If there is an increase in the supply of money prices will rise A decrease in its supply will cause

prices to fall Those holding this theory take into consideration all the other items in the equation of exchange especially M But they hold that V and V are fairly constant during a particular period of economic development and that T changes but slowly They of course understand that in the United States M bulks much larger than M but they urge that under our reserve requirements there is a close connection between M and M M tends to increase or decrease with a rise or fall in M

The following is the line of reasoning showing the connection between the amount of money in circulation and the price level Let us assume that M is increasing because of an increase in gold production In addition to more money in circulation bank reserves will increase and M will expand to an even greater extent than M People will now have more money and more bank deposits with which to make purchases These extra dollars will be offered for goods and the keener competition of buyers will cause P to rise The great rise in prices in the United States between 1914 and 1918 is sometimes used to illustrate the manner in which an increase in the supply of money causes prices to rise Before we entered the War the Allied Powers made vast purchases in the United States A part of their payments was made in gold which expanded our monetary supply more particularly increasing our bank reserves In the same period the establishment of the Federal Reserve Banking system made it possible for each dollar of gold to act as reserve against larger amounts of bank deposits After 1917 the United States financed a large part of its war time activities by the sale of bonds the purchase of many of these bonds being made possible by credit which ultimately came from the Federal Reserve Banks The government entered the market with this borrowed purchasing power in competition with private buyers Since the supply of money and bank deposits had increased more rapidly than the supply of goods prices rose If the argument runs the government had made its purchases from the proceeds of taxes instead of from bank created credit there would not have been such a rapid rise in prices Under this method there would have been a diversion of money and bank deposits from private individuals to the government and private individuals would have had less funds to offer for goods There would have been less expansion of M and particularly of M and prices would not have reached the heights of 1920

There is no questioning a great degree of validity in the quantity theory of money Secular or long run price trends are especially dependent on the quantity of money in circulation In the past periods of rising prices have been periods in which there has been a great increase in the production of the monetary metals In like manner downward secular price movements have coincided with periods of small production of the monetary metals

Much greater qualifications however must be attached to the volume

of the monetary supply as the causatıve force ın the shorter run cyclıcal prıce fluctuatıons As has been shown earlıer ın such perıods V and V may vary even more wıdely than M and M In perıods of depressed busıness actıvıty the volume of money may be as great as durıng more actıve busıness condıtıons Bank reserves may be very large But because of lack of confidence ın the prospects for profits busıness men reduce ınvestments ın new plants and curtaıl productıon ın the establıshed ones Thıs slows up the velocıty of money causes M to shrınk and reduces the velocıty of the shrunken volume of M In such perıods fallıng prıces tend to cause prıces to fall stıll more Busıness men seeıng a declınıng prıce level, fear stıll lower prıces and postpone purchases and thıs lessenıng of buyıng causes prıces to sınk further Durıng the upswıng of the cycle an opposıte sıtuatıon exısts Busıness men are optımıstıc concernıng the prospects for profits They expand ınvestments and ıncrease output Thıs causes an ıncrease ın the velocıty of both M and M and the ıncreased credıt demanded from banks causes M to expand close to the reserve lımıts Rısıng prıces make busıness men eager to buy before thev rıse stıll more and thıs ıncreased eagerness causes prıces to rıse to a hıgher level

Thus ın the cyclıcal prıce movements the other ıtems ın the equatıon of exchange—the velocıty of money and of bank deposıts the volume of bank deposıts the volume of trade and even the prıce level ıtself—ın addıtıon to the volume of money play causatıve roles ın the determınatıon of the prıce level

In recent years governments have not been content to let the prıce level be set by the at least semı automatıc forces that we have been descrıbıng Especıally under the New Deal ın the Unıted States there have been definıte attempts to manıpulate and control the level of prıces Some of these attempts and other proposals for controllıng prıces wıll be consıdered ın the followıng chapter

CHAPTER 19

CONTROL OF THE PRICE LEVEL

What Is a Desirable Price Level?

Early in his administration President Franklin Roosevelt announced that one of his purposes was to raise prices to the desired level and then to maintain stability at this level While the policies of the Roosevelt administration for the control of prices have probably been more forceful and more varied than ever before nevertheless there were many such proposals and attempts long before the New Deal was inaugurated Some of these proposals have been for the purpose of mitigating injustices arising from changes in the price level others would attempt to prevent price fluctuations

Before discussing the various proposals and policies for stabilizing prices it must be made clear that care should be taken in determining the level at which price stabilization is desirable Despite the evils brought about by fluctuating prices which were discussed in the preceding chapter stability achieved at a wrong level might have worse results on the economic system For example few would deny the undesirability of price stabilization at the low level of 1932 If this had been accomplished there would undoubtedly have been wholesale liquidation and bankruptcy It would have been equally undesirable to have stabilized prices at the peak level of 1920 This peak was the result of extraordinary war conditions and if it had been maintained during peace times serious disturbances to our economy would have resulted It is of course much easier to show what price level would have been undesirable to maintain than to state positively what is the proper level The best guide that we can give is that if possible the price level should be stabilized at the point where a high degree of equilibrium has been established in the economic system The economic system may be said to have reached a high degree of equilibrium when the various factors of production are fairly fully employed and when the various industries are producing goods and services in reasonably proper proportion to each other It is unfortunate that there is no cut and dried formula for determining when such a level has been reached It is clear however that if price stabilization is to be attempted the determination of the proper level should be made by as expert and impartial a group as can be found rather than by any business interests which would gain if a certain level were established or in the hurly burly of a political campaign

Proposals for Mitigating Injustices Arising from Changes in the Price Level

To mitigate the injustices which changing price levels create in the debtor creditor relationship a tabular standard of deferred payments has been proposed Under this standard index figures of commodity prices would form the basis for the payment of obligations rather than the exact number of dollars involved in the transaction For example sup pose A lent B $1 000 when the index figure of commodity prices was 100 If the index figure is 110 when repayment is made A would receive $1 100 If the index figure should fall to 90 only $900 would be repaid The idea is that greater justice will be realized if debts are paid in pur chasing power equal to the amount borrowed rather than payment being made in the equal number of dollars The scheme could of course be applied to all contracts involving future payments such as savings bank deposits and life insurance policies Its adoption would naturally involve a great change in business activities Whether it would provide greater justice depends to a large extent upon the accuracy with which the index figure chosen represented changes in all the varied prices constituting the general price level

The somewhat similar suggestion that wage rates should be varied according to index figures of the cost of living has been made for the purpose of creating greater justice in the employer employee relationship Under this scheme if at the end of a certain period say six months, the cost of living had increased wages would be raised proportionately If the index figure had moved downward, wage rates would be lowered There is the question of course as to how accurately changes in the cost of living represent changes in the general price level There is usually a lag in such changes and securing the justice sought would be hampered by the prices received by the employer rising and falling more rapidly than the cost of living Furthermore basing wages on cost of living figures might check a rise in wages which was justified by the increased mar ginal productivity of labor Likewise the lag in the fall of the cost of living might cause wage rates to be maintained at a higher point than the value productivity of labor would warrant and thus cause unem ployment

Proposals for Preventing Fluctuations of the Price Level by Changing the Monetary Standard

It has been pointed out in a previous chapter that supporters of a bimetallic standard have contended that under such a standard there would be greater stability in the price level This belief is based on the alleged compensatory effect of the dual standard It is held that any change in the quantity of one standard monetary metal will tend to be

compensated by an opposite change in the quantity of the other If for example the quantity of gold in use as the monetary metal should de crease, thus causing prices to fall there would be a tendency for more silver to be injected into the monetary system which would check if not prevent falling prices It has also been shown in the earlier chapter that wherever bimetallism has been tried the principle of Gresham s Law that cheaper money tends to drive dearer money out of circulation has oper ated rather than the compensatory principle That metal which was cheaper on the market relative to the established mint ratio between the two money metals went to the mint for coinage and the dearer metal was driven from circulation The result of the bimetallic experiences has been therefore, that the cheaper money became the actual standard money and price fluctuations have tended to be greater than if the dearer metal had been used

The compensated dollar proposed by Professor Fisher would sup posedly stabilize prices without abandoning the gold standard Stabili zation would be achieved by varying the gold back of the monetary unit in proportion to changes in the price level The scheme would be operated in the following manner The gold dollar now contains 13 71 grains of fine gold The price level at the time the compensated dollar is inaug urated would be represented by the index figure 100 At certain intervals say every two months the gold backing of the dollar would be changed as the price index changed If the price level had gone up 1% the gold con tent of the dollar would be increased by an equal percentage If the price level had fallen 1% there would be an equal decrease in the dollar s gold content Naturally under such a system no gold money could remain in hand to hand circulation but the quantity of other types of money in circulation would vary with the amount of gold held in the Treasury And the dollar value of the Treasury gold holdings would vary as the weight of the gold dollar varied In addition to regulating the amount of money in circulation in accordance with the price level the Fisher pro posal would similarly affect bank reserves and therefore supposedly affect bank deposits If the weight of the gold dollar were increased the dollar value of the bank reserves would fall and the amount of credit they could extend would tend to be lessened This would tend to check the rise in prices If the weight of the gold dollar were decreased the dollar value of bank reserves would increase thus making possible a greater extension of credit If more credit were extended prices would tend to rise

In defending his ingenious proposal Professor Fisher insists that under the gold standard the dollar must be a rubber dollar either in respect to its purchasing power or to its weight The gold standard is desirable be cause greater confidence exists in a monetary system based on this precious metal But stable purchasing power is a more important quality of a good money than a stable weight for the monetary unit The conclusion there

fore is that all the advantages of the gold standard plus monetary stability can be realized by the adoption of the compensated dollar

There is doubt however concerning the ability of the compensated dollar to produce the desired results In the first place it will be noticed that the dollar is to be compensated after the price change takes place The scheme therefore is not designed as a complete preventive of price changes it would only serve as a check on their magnitude This however is no strong argument against the proposal for limiting the degree of price changes would often be most desirable But there are doubts concerning the efficacy of the proposal in preventing wide price fluctuation Changing M in relation to price fluctuations would not necessarily affect M V, V and T in the equation of exchange A change in the gold content of the dollar would change the value of bank reserves but expansion or contraction of bank reserves does not necessarily react in a similar fashion on bank created credit or on bank deposits Nor would a change in M necessarily produce the desired results in the velocity of money and of bank deposits or in the volume of trade The very drastic decrease in the gold content of the dollar in 1934 and the ensuing 100% increase in bank reserve requirements measures taken to affect M and M have not resulted in great price changes It is doubtful if the compensated dollar would prove more effective

In addition to its probable failure to produce its expected results, the compensated dollar would create great complications in foreign trade transactions If a deferred payment was involved in the transaction no one would know exactly what his commitments would amount to at the end of two months An international agreement for the establishment of a compensated standard is apparently in the realm of the fantastic

A number of recent writers have proposed a managed currency divorced from the gold standard for the stabilization of price and business fluctuations A managed paper currency would be introduced in place of the gold standard, and the quantity of such money as well as of bank credit would be manipulated in such a fashion that price and business stability could be maintained The controls would be carried on through the Treasury policies of money issue borrowing and repayment and through the discount rate and open market policies of the central banks The price index would be used to determine the monetary and banking policies To obviate foreign trade difficulties gold payments would be made in such transactions

Difficulties similar to those discussed under the compensated dollar would be likely to appear if a managed paper currency were adopted Would bank deposits vary in the desired fashion even under the impetus of changes in the discount rate and in open market operations? Might not changes in the velocity of money and of bank deposits offset changes in their volume? In addition would it be certain that the currency would

be managed scientifically or would there be a tendency to increase its quantity as a temporarily more painless method of meeting governmental expenditures than through the levying of taxes? If this should occur excessive inflation would result and the managed currency would lead to a great rise in prices instead of giving greater price stability

Control of Bank Credit for the Stabilization of Prices

Since checks drawn on bank deposits are employed in some 90% of the business transactions of the United States they comprise our most important type of currency If has been shown previously that a high proportion of these deposits arise from credit extended by the banks Therefore if control over the volume of our currency is to be effective its principal influence must be on bank created credit

Several means are available to the Federal Reserve Bank officials that may be used in the attempt to expand or to contract the volume of credit These include changes in rediscount rates open market purchases and sales changes in member bank reserve requirements and the use of various forms of moral suasion

If the Federal Reserve officials decide that prices are in danger of reaching too high a level they will raise the rediscount rates of the Reserve Banks At the higher rates it becomes more expensive for the member banks to use the Reserve system s rediscounting facilities In turn the member banks will supposedly charge a higher rate for loans to their customers and a contraction in the volume of credit will occur which will tend to check the rise in the price level Conversely in times of falling prices the Reserve officials can lower the rediscount rates This supposedly will encourage the use of the rediscounting facilities by the member banks which in turn will lend to customers at cheaper rates The expansion of credit which results from this action will put a stop to falling prices

Concurrently with changes in the rediscount rates the Federal Reserve Banks may engage in the purchase or sale of securities in the open market for the purpose of controlling the volume of credit If a contraction of credit is desired securities held by the Federal Reserve Banks principally obligations of the United States government will be sold to member banks and others Payment for these securities will result in a reduction of the member bank reserves on deposit with the Reserve Banks and therefore in a curtailment of the amount of credit member banks may extend If the Federal Reserve officials desire to expand credit securities will be bought in the open market Payment for these securities will increase the reserves of the member banks on deposit with the Reserve Banks and the member banks will now be in a position to expand the volume of credit

In an effort to increase the control of the Federal Reserve system over

the volume of credit the banking legislation of the early 1930s empowered the Board of Governors to make changes in the member bank reserve requirements The reserve percentages could not be made less than those in effect in 1933 nor could they be raised to more than twice that level The Board of Governors have used this new power on three occasions In two steps the reserve requirements were raised to the limit permitted by the law Later they were reduced to the present requirements of 22¾ 17½ and 12% on demand deposits of the member banks in the central reserve cities reserve cities and other places respectively An increase in member bank reserve requirements decreases the amount of credit which a member bank can extend on a given amount of reserves A decrease in the reserve percentage requirements has the opposite effect

In the attempt to make their policies more effective Reserve Bank officials at times through public statements and through private correspondence and interviews with officers of member banks seek to secure the cooperation of bankers and business men If for example the Reserve officials believe that business is expanding in an unhealthy fashion they may make public and private statements to this effect hoping that the prestige of their position may influence credit policies Likewise at other periods they may urge more liberal credit policies As a last resort, the Federal Reserve Banks may refuse to lend to a member bank which refuses to cooperate in carrying out the policies of the Federal Reserve system

The above controls over credit extension that may be used by Federal Reserve officials have not been as effective as might be desired It must be remembered that a majority of the banks in the United States are not members of the Federal Reserve system While it is true that the member banks carry on a greater volume of banking operations than do the non member banks, nevertheless the Reserve officials have but a rather tenuous influence over a considerable proportion of bank created credit Furthermore even among the member banks there is a tradition against rediscounting This limits their use of Federal Reserve credit facilities and thus limits the effectiveness of changes in the rediscount rates But a more important hindrance to Reserve Bank controls has been the failure of higher interest rates to contract the demand for loans made by member bank customers and the failure of lower rates to expand their demands When prices are rising and business is booming an additional 1 or 2% charge for loans is often ineffective in reducing the demand for credit Let us suppose, for example that a business man believes that by borrowing $100 000 for three months for the purchase of raw materials he can make large profits An increase of even 2% in the interest rate will raise the cost of the loan by only $500 and this is not likely to deter him from borrowing When business is depressed prospects for profits are gloomy and business men are not likely to borrow extensively at even

extremely low rates In such periods entrepreneurs are doubtful that their activities will bring a return even equal to the principal borrowed and therefore even if the controls used by the Reserve officials result in extremely low interest rates the demand for loans will be small In the United States in recent years practically all banks—Federal Reserve Banks member banks and non member banks—have had reserves far in excess of their requirements and they have wanted to expand their loans The business outlook however has prevented business men from borrowing and bank reserves have continued to pile up

Policies Under the Roosevelt Administration for Controlling the Price Level

The Roosevelt administration came into office in March 1933 when the country was in the depths of depression Prices had sunk to very low levels business was stagnant security values had shrunk and in some cases had almost disappeared and many banks were on the verge of closing The new administration decided that prices must be raised if bankruptcy for practically all businesses was to be avoided In addition to the use of the Federal Reserve policies for expanding credit described above several other devices were employed

Among the best known of these was the devaluation of the dollar the gold content of the dollar being reduced by approximately 40% The theory was that the devalued dollar would become cheaper in relation to goods and services and that the higher price level would take business out of the doldrums As a matter of fact the mere devaluation of the dollar in itself would not necessarily result in rising prices As we have seen an increase in the quantity of money is not sufficient to raise prices The money must be used in business transactions In so far as the cheapening of the dollar as well as other governmental policies increased business confidence it did have the effect of encouraging business activity and raising prices Through its effect on increasing our sales abroad the devalued dollar was also supposed to increase the domestic price level The cheaper dollar reduced the prices of our goods in terms of foreign currencies In theory this should have increased the sale of our automobiles cotton, wheat and other export commodities Greater sales by these important industries would increase their prosperity and people engaged in them would become better customers of the purely domestic industries All industries would thus feel the beneficial effects of the expanded foreign trade Our foreign sales did not however increase to the extent expected Other countries also devalued their currencies thus removing the advantage our cheaper dollar gave to our exporters More important many countries were engaged in drives for economic self sufficiency as a means of military preparedness Imports were limited by higher tariffs, quota restrictions and currency controls

There has been an increase in the price level since the devaluation of the dollar but there have been so many other factors involved in the situation that it is impossible to state to what extent devaluation has been responsible Certainly prices have not risen by 40% or proportionate to devaluation The argument of some that prices are 40% higher than they would have been without devaluation takes us too far into the realm of the unknown to be considered

The good reason given for the enactment of the Silver Purchase Act which makes it mandatory for the Treasury to continue buying silver until the silver supply equals one fourth of the total monetary value of the country s stock of both gold and silver was that such purchases would broaden the monetary base leading to easy money and higher prices The real reason for the Act was to extend a subsidy to silver producers After the devaluation of the gold dollar our monetary base was sufficiently broad to fulfill all the currency and credit needs of the country The silver purchases do make possible an unnecessary addition to our monetary supply since the Treasury gives a value for monetary purposes of $1 29 to each ounce of silver bought Much of this silver has been bought for around $ 60 an ounce Therefore the Silver Purchase Act gives silver a monetary value about twice as great as its value as a commodity Much of the silver bought has not been put into circulation For the present it lies idle representing a useless expenditure of public funds If, however, a great business boom should again occur in which all existing monetary reserves were used up there is a possibility that the idle silver might be put into circulation This silver would put an added strain on the agencies attempting to prevent runaway prices and speculative booms

Dollar devaluation was accomplished by raising the mint price of gold from $20 67 to $35 an ounce Quite rightly the government prevented the then holders of gold from realizing the handsome profit arising from its increased price The government took the profit which amounted to over $2 800 000,000 Of this sum $2 000 000 000 were placed in the Stabilization Fund to be used for the purpose of preventing wide fluctuations in foreign exchange rates In the administration of this Fund the Secretary of the Treasury is empowered to buy and sell foreign exchange and certain types of domestic securities These transactions have the same effect on the ability of banks to extend credit as do the open market operations of the Reserve Banks Treasury purchases add to bank reserves and to their lending capacity Treasury sales contract bank reserves and lending capacity

The adoption by the Treasury in 1936 of the policy of sterilizing new additions to our monetary gold stock was an added step toward Treasury control of the money and credit market The Treasury paid for gold with government bonds instead of with money and the gold became inactive in the Treasury vaults Later when the Treasury wished to make credit

easier it paid out gold certificates based on this gold thus adding to the supply of Federal Reserve Bank reserves

The Treasury by shifting its cash balances from Reserve Banks to member banks and vice versa can have an appreciable effect on the credit expansion capacity of our banks A shift from member banks to Reserve Banks decreases the reserves of the member banks a reverse shift will have the opposite effect Premiums paid under the Social Security Act strengthen this type of Treasury control The Treasury may permit a considerable proportion of the premiums paid in a particular period to remain in its cash balance It can then vary the deposit of this enlarged cash balance between Reserve Banks and member banks in accordance with its policy of expanding or contracting credit

Despite all these controls over the volume of money and credit which during the Roosevelt administration have been used in the main for monetary and credit expansion they have not been very effective in getting business men to make use of the available funds The outlook for profit making continued dark and business men were slow to borrow for either investment purposes or for expanding production in established plants This curtailment of production and of industrial expansion prolonged the vast unemployment of workers which had begun in 1929 One of the most highly controversial of the policies of the Roosevelt administration has been its attempt to reduce this unemployment by governmental use of idle funds for various public works projects

The theory and even the practice of governmental expenditures as at least a partial solution of the unemployment problem did not originate with the New Deal but under it the idea has been put into operation to a degree never before tried The theory is that in periods when there are both idle men and idle funds the government by using the funds for public works undertakings will directly put many men to work Indirectly government orders for the various materials used on the projects will increase production and employment in private industries This is sometimes known as 'priming the pump The government will supposedly start idle funds to circulating the more active funds reach private industry and the industrial pump starts working

Whether such governmental expenditures have the desired results depends in large measure upon the source of the funds used by the government and upon the effect of such expenditures upon business confidence If the funds are derived from taxes in large measure there will be a mere diversion of expenditures Most of the taxpayers would have spent such funds for other goods and services and no increase in demand for labor and no tendency to rising prices will ensue Likewise if the funds used by the government are borrowed from individuals who would otherwise have spent them or invested them in business undertakings no additional purchasing power will have been put into circulation But if these

funds come from idle bank balances or more particularly from additional bank created credit there is a fair probability of obtaining the desired results As an offset however there is the possibility that very heavy government borrowing may weaken confidence in the financial stability of the government or may make business men fearful of heavy taxes in the future for the repayment of the government loans This lack of confidence and fear of taxation may reduce private expenditures for production to such an extent that the beneficial effects of the governmental expenditures will be counteracted

It is impossible to say to what extent the spending program of the Roosevelt administration has increased the effective volume of bank deposit currency or has increased the velocity of money and deposits The expenditure of billions of dollars has certainly put millions of people to work on public projects which in turn has caused an undetermined number to secure reemployment in private industries Whether there has actually been less employment in other private industries because of this program it is difficult to conjecture If a public works program is to play an effective part in smoothing out cyclical price fluctuations and in alleviating cyclical unemployment it must be planned over a period of years coinciding as nearly as possible with the length of the cycle In prosperous years when business is active and prices are rising the government should reduce its current expenditures for public works These reduced expenditures will tend to mitigate the upward swing When business is dull and prices low, the government can use public works financed by borrowing for the purpose of giving employment and raising prices The loans incurred to meet the depression spending should be repaid during the next prosperous stage

All of the attempts of the Roosevelt administration to expand the volume of currency and credit, to put idle funds to work through governmental expenditures and its various other policies have not sufficed to increase production to the point where there is relatively full employment There are, therefore some who have advanced more drastic proposals for the solution of our monetary and credit difficulties and for the mitigation, if not prevention of the major ills of our economy

More Drastic Proposals

One of the most interesting of such proposals which has been advocated by a number of economists is called the 100% money scheme The ideas advanced by its proponents have differed somewhat but the following steps are frequently suggested (1) outright federal ownership of the Federal Reserve Banks, (2) complete separation of the deposit and lending functions of banks (3) maintenance of 100% reserves with the Federal Reserve Banks by all banks accepting deposits and providing checking facilities (4) displacement of private bank created credit

by Federal Reserve Bank created credit (5) the notes and deposits of the Reserve Banks to take the place of all other currency in circulation (6) the establishment of a National Monetary Authority charged with the administration of a legally prescribed monetary principle[1]

Under this proposal there would continue to be private ownership and operation of banks for receiving deposits and also for the extension of both long term and short term credit The deposit banks however would be required to maintain 100% reserves against their deposits and in consequence would not be able to create credit Their earnings would come not from interest on loans but from a service charge for cashing checks The short term credit institutions would be substantially in the same position that investment trusts are at present They would obtain funds for lending by the sale of their own stock and would no longer be able to expand and contract the circulating medium as at present

The determination of the expansion and contraction of the circulating medium would be in the hands of the National Monetary Authority operating through the federally owned Reserve Banks If it was deemed that economic conditions called for an expansion of the circulating medium the Authority would instruct the Reserve Banks to issue more currency and to increase the volume of credit through the purchase of securities in the open market If it was deemed expedient to contract the circulating medium the Reserve Banks would be instructed to contract the volume of currency and to sell securities in the open market In this way, it is held, a central authority working under an established rule will be able to regulate effectively the circulating medium and thereby to bring a high degree of stability to the price level and to decrease markedly the violence of business fluctuations

The question again arises, Will the manipulation of the quantity of money and credit be able to achieve the desired results? If business men are highly confident concerning the outlook for profits there will be a very rapid turnover of the quantity of money and credit decided upon by the Monetary Authority and this increased velocity will tend to cause prices to rise and business to boom If the outlook for profits is not bright there will be a slow turnover of the circulating medium prices will tend to fall and business will slump There would also be the danger that the decisions of the Monetary Authority might be unduly influenced by the interests of some pressure group and policies might be inaugurated that would be injurious to other groups not so well organized

There are some who insist that federal ownership of the Reserve Banks is insufficient that there must be socialization of the entire banking system If, they say, private banks are permitted to make loans even if limited to the amount of their own securities which they can sell there

[1] See H C Simons *A Positive Program for Laissez Faire* (University of Chicago Press 1934) pp 23 24

will be no direction of this credit to the proper industries Some industries which in the general welfare should be enlarged may not receive the credit instead less worthy enterprises may be able to secure loans If all credit extending institutions however, are socialized credit can then be made available to the enterprises decided upon by the officials of the socialized banks or probably by some higher governmental authority

Even if it be accepted as certain that decisions by the governmental authorities concerning the use of credit would be wiser and of greater benefit to the economic welfare of the majority it is doubtful if socialized credit could fully solve the problem of fluctuating prices and business conditions The assumption is that most other industries would continue under private ownership and operation The problem would remain Would the desired industries seek the credit? Negatively socialized banks could prevent credit from being used by certain industries Positively they could not force industries to expand when the price level and business conditions seemed to make such expansion desirable Socialized banking would be in a position to check great speculative booms it would not be so able to get business to use more credit during depression periods But since it is likely that the slumps would be less severe if the speculative booms could be retarded socialized banking might aid in regularizing prices and business fluctuations

The most far reaching proposals for stabilizing the economic system call for the establishment of a planned economy These proposals vary widely Some merely suggest that an economic advisory council operating under governmental auspices be established with the function of conducting research in all phases of economic activities Conclusions drawn from this research would be presented to Congress to the executive and administrative branches of government and to the nation s business men It is the expectation that governmental economic policy would be greatly, if not wholly, influenced by the findings of the advisory council and that business men would expand or contract production in accordance with the advice of the council Other plans provide for authoritative planning boards whose orders must be obeyed by business men and presumably by the governmental agencies concerned with economic affairs Under still other plans it is held that there can be no comprehensive planning so long as most industries are under private ownership and operation Planning and socialism are said to be synonymous

While there is this wide variation in the planning proposals nevertheless they all agree that there cannot be stability in production employment, and prices unless all parts of the economy can be made to mesh through some over all direction If production is to be expanded money and credit must be expanded If the expansion of money and credit comes first it must be certain that the additional funds will be used by industry If it seems desirable that prices should rise all the various forces

leading to higher prices must be put into operation in a systematic rather than the present more or less hit or miss fashion

The promise that a planned economy will bring greater security and stability has a wide appeal especially during depression periods when millions are jobless and most others have had serious cuts in their standard of living It is very questionable however whether there can be any real planning unless it is of the authoritative type The introduction of authoritative planning will necessarily greatly change our economic traditions, if not our practices It is difficult to believe that private production could long continue But whether the planned economy operated under private ownership or under socialism there must be greater control over the choice of goods by consumers and of jobs by laborers than exists even today No planning of production can be very effective if it must depend upon the vagaries of consumers choices If it is planned to expand the production of A and to contract the production of B there must be some rapid means of shifting laborers out of B and into A Wage variations between the industries would probably prove too slow a method for a comprehensively planned economy

It is also questionable whether the degree of political democracy present today could continue under a comprehensively planned economy Plans to be effective must be in operation for a number of years If rival political parties alternate in administering the agencies of government it seems scarcely likely that long term plans could be drawn Our democracy today functions largely through the rival claims of various pressure groups for representation of their interests These claims are frequently in opposition to each other A planned economy must surely suppress to some degree at least the dissident pressure groups after the plan for the next term of years has been formulated It may not be strange that in those countries where the most comprehensive planning exists there is room for only one party, and that after the plans have been decided upon it is not healthful to object to them

CHAPTER 20

FOREIGN EXCHANGE

Reasons for Foreign Trade

Trade is carried on between countries for the same reasons that dif ferent individuals and different sections of the same country trade with each other and in the main it is carried on by individuals and firms just as is trade within one country Speaking of trade between England and the United States is merely a shorthand expression for trade between business men of the two countries Inter governmental purchases and sales do take place but they do not ordinarily bulk large

Specialization and exchange of specialized products by individuals within a country and by the different sections of a country have led to more efficient production of goods and services and thus to higher stand ards of living One firm specializes in the production of shoes another in the production of furniture and a third in the production of books Maine specializes in the production of potatoes Iowa in corn, Michigan in automobiles Florida and California in citrus fruits and so on In like manner the United States England, Germany Brazil Japan and the other countries have their specialized goods to whose production it is most advantageous for them to devote their productive factors

Specialization among countries is based on a variety of factors just as it is within a country It may be due to climatic and soil conditions as, for example the production of cotton in our southern states of coffee in Brazil or rubber in the East Indies It may be based on rich mineral deposits as of coal and iron in the United States and England or gold and diamonds in South Africa Proximity of most of the inhabitants of a country to the sea may make it a great maritime nation as in the cases of England and Norway The stimulus of an early start may develop particular aptitudes among a people as are exhibited by the textile indus try of England and the chemical industry in Germany Recent inventions and methods introduced into agriculture manufacturing and other fields of enterprise have lessened the advantages based on soil climate mineral resources and acquired aptitudes but they have not made it possible for any country to become self sufficient—much less for any country to pro duce all commodities as cheaply as it can buy some of them through the exchange of its specialized products

Specialization and the exchange of specialized products between farm

ers and manufacturers between the wheat growing Middle West and the cotton growing South coffee producing Brazil and automobile manufacturing United States the tin mining and rubber growing East Indies and machine making United States and western Europe are easily understandable Climate soil and natural resources give such clear advantages to each individual section or country that specialization and exchange seem only sensible Yet it is true that by undergoing sufficiently great expense the various sections and countries could produce for themselves the products named above or at least reasonably usable substitutes Coffee could be grown in the United States at a cost of a dollar a pound or more, synthetic rubber could be produced at two or three times the cost of natural rubber bought abroad However where the difference in cost of production is as great as this there is usually little contention that the goods should be produced and bought at home Where it is said that a country has an absolute advantage in the production of a commodity most people hold it proper that such country should exchange this product for goods in whose production other countries have absolute advantages

But the controversy rages as to whether a country should specialize in the production of commodities where it has only a comparative advantage and import goods where its comparative advantage is less That is let us assume that the United States can produce all commodities more efficiently than another country but that in the production of some commodities its superiority is very great while in the production of others its advantage is much less Should the United States engage in trade with the other country? It is surely to the advantage of the people of a country that its resources be applied to their most effective uses By specializing in the production of those commodities in which its comparative advantage is greatest and exchanging them for the goods of the other country in whose production that country's comparative disadvantage is least both the people of the United States and of the other country will benefit Naturally the United States will want to produce and sell the greatest possible amount of the goods in which its advantage in production is great To get the greatest advantage of such specialization sales abroad are frequently necessary But for the goods to be sold abroad purchases must be made abroad and it is clearly advantageous both to us and to the people of the foreign country that we should buy those things in which our advantage and their disadvantage are least

This principle of comparative advantage is not denied when applied to individuals in, or sections of, the United States A lawyer for example, may be a better typist than any stenographer he could hire But it would be extremely foolish for him to spend his time typing briefs when in the practice of law he could earn several times as much per day as the cost of a typist's services An acre of land in New York City may be unusually good for truck gardening but it can earn so much more rent as a build

ing site that its use in growing vegetables is not considered California citrus growing land might well produce more wheat per acre than the best of the mid western farms The profitability of growing citrus fruits however prevents the land from being used for the cultivation of wheat

Although the same economic principle is equally operative in the trade among nations nationalistic and other political considerations cause serious restrictions to be placed on the free flow of such trade It seems perfectly logical that even if the United States could produce all commodities more efficiently than Canada that our country should devote its resources to the uses in which our relative efficiency is greatest and exchange such goods for those in which Canadian production is relatively least inefficient But a political boundary line separating the two countries has upset the working of an economic principle which is generally held to be advantageous when operating within the borders of the United States

The Protective Tariff

The best known and most widely used restriction on international trade is the protective tariff In form a tariff is a tax levied on the importation of goods into a country But the protective tariff differs from most other taxes for its purpose is not to raise revenue for the government Its aim is to prevent or at least to hinder, the importation of certain goods and thereby to shelter domestic producers from foreign competition The reason however why such domestic producers must be sheltered is that to secure land labor, and capital for their enterprises they must compete with other more efficient domestic industries They cannot pay the prices established for these factors of production by their use in our more efficient industries and still sell their products for as low a price as foreign producers can set The protective tariff enables the relatively inefficient domestic industries to secure a price sufficiently high so that they can successfully bid for the domestic factors of production and thus causes an uneconomical allocation of these factors Moreover since the protective tariff curtails our foreign purchases it necessarily reduces our foreign sales These sales have been made by our more efficient industries and again the tariff gives a blow to them Furthermore, the tariff by raising the prices of many goods injures consumers The protective tariff is thus a means by which relatively inefficient industries are subsidized by the more efficient domestic industries and by the consuming public

Some of the principal arguments for protection are it gives the home market to domestic producers , it makes for fuller employment and higher wages it is necessary for the development of infant industries it aids in military preparedness

It is true that in so far as protective tariffs keep out foreign made goods the sale of similar domestically produced goods is increased But at the

same time the curtailment of imports decreases the sales of our export industries for it is impossible over a period of time for a country to sell abroad and not buy abroad Therefore protection gives no added market to domestic producers in general The market of the relatively inefficient industries is enlarged that of the relatively efficient industries is decreased From this can be seen the fallacy in the fuller employment higher wages argument for protection Protection does cause greater employment in the sheltered industries and makes it possible for these industries to pay wages equal to those maintained in the efficient industries But by reducing their export market protection decreases the demand for labor by the relatively more efficient industries and the result is a shift of labor from efficient to inefficient industries This causes higher prices and lower real wages

At one time it was said in the United States that higher American wages made a protective tariff necessary Later it has been urged that the tariff is responsible for higher wages As a matter of fact the relatively high scale of American wages has been due to the relative scarcity of labor in proportion to natural resources The relatively scarce factor tends to secure relatively high remuneration Nor has the relatively high wage rate weakened the competitive position of American manufacturers and other producers What is important in determining the labor cost of production is not the wage rate per day but the labor cost per unit of product An American worker in a certain industry may secure $8 per day while his English counterpart receives but $5 The American laborer however may turn out twice as many units per day as the English workman and thus the American labor cost per unit of product is smaller than in England

According to the infant industry argument a developing country should provide protection to its new industries until they become strong enough to compete on equal terms with the established firms of the more industrialized nations There is some degree of truth in this argument but unfortunately the infants never seem to grow up Some of the infants who were given protection just after the War of 1812 still vociferously seek shelter Moreover if an industry is well suited to a country there is little reason to believe that it will not develop without protection although its development will probably be slower and more gradual Certainly within the borders of the United States there has been a shifting of industries without the advantages of protection The old established cotton textile and shoe industries of New England have scarcely been able to protect themselves against the lusty textile infants of the South and the shoe infants of the Middle West

The military preparedness argument for protection has long been used but it has gained renewed strength during the past decade in which many countries have been diverting more and more of their resources to war

purposes The argument is that to achieve military efficiency a country must be economically self sufficient In time of peace, therefore, domestic industries producing vital military supplies must be built up regardless of cost It is of course highly questionable whether any country can become economically self sufficient for a major war But even if it can a protective tariff is not a desirable means to this end Military preparedness should be secured by other forms of taxation than one that falls on consumption Direct subsidies to war industries will get them operating faster than will indirect subsidies arising from tariffs

Other Restrictions on Foreign Trade

Particularly since 1929 many countries have not been content with protective tariffs as devices for limiting imports and otherwise controlling their foreign trade Direct quotas on imports, licenses, government boards to determine imports, foreign exchange controls currency manipulation barter trade, and other means have been used In the earlier part of this period these measures were employed in the hope of providing relief from the ravages of the depression later they were merely part of the feverish preparation for war Where quotas were established only a certain definite amount of particular commodities could be imported regardless of their price and sometimes specific quotas were assigned to individual foreign countries The licensing provisions required an importer to secure a permit before buying goods abroad At times all purchases abroad were required to be made through governmental boards The foreign exchange controls and currency manipulations will be discussed later in the chapter but their purpose has been to ensure that the foreign trade of the countries concerned shall be expanded and that it enters the channels decided upon by the political authorities In addition to using all the previous devices mentioned Germany especially has made use of barter trade For example Germany has made agreements with Balkan firms to exchange machinery for raw materials The raw materials reach Germany but at times the Balkan nations have found that instead of the desired machinery it has been shipped vast quantities of aspirin or harmonicas

With the introduction of all these restrictive devices it is rather remarkable that foreign trade continues to the extent that it does It is not altogether true that discussion of foreign trade is the discussion of a vanishing subject The advantages of international specialization are so great that despite tariffs other restrictive devices and even war foreign trade continues and there is every reason to believe that it will go on after the present war although possibly under somewhat different conditions

Invisible Items of Trade

In addition to the exchange of commodities among nations which is known as the visible items of trade—trade that passes through the cus

toms houses—there are many invisible items entering into international commercial intercourse Among these are loans and capital investments abroad interest payments and repayments of principal on foreign loans and capital investments tourist expenditures payment of freight and insurance charges to foreign firms gifts sent by the people of one country to those in another All of these items affect the international balance of payments in the same way as do the purchase and sale of commodities In fact a so called unfavorable balance of trade—greater imports than exports—may be more than counterbalanced by a favorable balance of the invisible items so that a country s balance of payments may be favorable

Care, however, must be taken in speaking of favorable and unfavorable balances A country can only continue having a favorable balance of payments over a long period by continuing to invest its favorable balance abroad Sooner or later moreover interest payments and repayment of the principal will overtake the amount of annual foreign investment and the lending country must either accept more goods and services than it sells or forego repayment In other words debits and credits in foreign transactions ultimately balance just as in domestic transactions unless failure to meet obligations occurs

Foreign Trade of the United States

Due to the diversity of its climate and resources and to the size of its domestic market the United States is less dependent upon foreign trade for its economic welfare than are countries like England Germany or Japan Over a period of years our foreign trade has constituted only about 10% of the total volume of our trade But here as elsewhere averages may be misleading Before the depression of 1929 over half of our cotton over one third of our tobacco and pork products two fifths of our refined copper, two fifths of our typewriters one fourth of our agricultural machinery and one third of our kerosene and lubricating oil were exported There are of course other industries like dairy farms electric power plants, and brick manufacturing that export little or none of their output Naturally the prosperity of the exporting industries depends to a considerable extent on their foreign markets and when foreign sales are reduced not only do the exporting industries suffer but also all other industries which sell goods to the exporting industries and their employees

Likewise we are dependent on purchases abroad for our supplies of coffee tea tropical fruits raw silk rubber tin manganese and other commodities Without them many of our industries would be seriously crippled and our standard of living lowered It is conceivable that the United States might get along without foreign trade but the result would necessarily be a most drastic reallocation of our productive resources and lower real incomes

As the United States has changed from an almost purely agricultural country to an important manufacturing nation the volume and nature of its foreign trade have changed considerably In 1860 our exports amounted to $334 000 000 and our imports to $354 000 000 84% of these exports consisted of raw materials and foodstuffs while 59% of our imports were manufactured goods In 1929 the last year of great prosperity our exports amounted to $5 241 000 000 and our imports to $4 400 000 000 Of our exports in this year raw materials and foodstuffs constituted but 36% and our imports consisted of 57% raw materials and foodstuffs and of only 43% manufactured goods In 1938 the year preceding the outbreak of the present war our exports had shrunk to $3 094 000 000 and our imports to $1 960 000 000 Of these exports raw materials and foodstuffs amounted to 34% and manufactured goods to 66% Of our imports in this year raw materials and foodstuffs constituted 58%

In considering these statistics of foreign trade it must be remembered that they are dollar figures and are therefore greatly affected by changing price levels For example the great shrinkage shown between 1929 and 1938 was to a considerable extent due to a drastic fall in the price level For the same reason care must be taken in drawing conclusions concerning shifts in foreign purchases and sales of raw materials and manufactured goods In the period under consideration there may have been a greater fluctuation in the prices of raw materials than of finished goods

Nearly half of our total foreign trade is carried on with Canada Great Britain, France and Japan In 1938 our exports to Great Britain amounted to $521 000 000 to Canada $467 000 000 to Japan $239 000 000 to France $133 000 000 Germany, the only other country in the $100 000 000 class took our goods to the value of $107 000 000 Our chief imports in 1938 came from the following sources Canada $260 000 000 Japan $126 000 000 Great Britain $118 000 000 British Malaya $112 000 000 Cuba $105 000 000 Brazil $94 000 000

Raw materials and foodstuffs are our leading exports to European countries but they also take considerable quantities of typewriters, automobiles and other manufactured goods Canadian purchases consist more largely of finished goods while Japan has been a heavy buyer of scrap iron and petroleum products Wood and paper bulk largest in our imports from Canada Our large purchase of rubber is the principal item imported from British Malaya and the Dutch East Indies Coffee from Brazil sugar from Cuba and raw silk from Japan make these countries important to our import trade

While the business interests of the United States have constantly given allegiance to the doctrine of laissez faire they have rarely let it interfere with their support of protective tariffs Protection secured the early support of Alexander Hamilton, and beginning after the War of 1812 and increasing in extent after the Civil War tariff protection has constantly

sheltered many American manufacturing industries Farmers of the South voiced their opposition to it for their principal crop was cotton which was for many years our leading export commodity But the most vociferous pressure groups demanded protection and they secured it whether Republicans or Democrats were in office During the latter half of the nineteenth century vast sums of European capital were invested in American enterprises It then became necessary for the United States as a debtor nation to export more than she imported in order to pay interest on these investments But our loans abroad during 1914 1918 and in the early post war years changed our position from a debtor to a creditor nation If we were to receive payment of interest and principal on these loans it became clearly necessary for the United States to import more than it exported

In the years after the First World War certain groups who formerly were ardent protectionists became favorable to freer trade relations Many important banking interests with foreign investments changed their views Moreover some manufacturers now felt not only secure from foreign competition in the domestic market but were becoming large exporters In part due to these shifts in interest and in part due to the lower tariff policy of the Democratic party in 1934 the Reciprocal Trade Agreements Act was passed Under this Act the President is empowered to make agreements with foreign nations involving tariff changes without referring the agreements for Congressional approval Limitations on these agreements are duties may not be raised or lowered more than 50% articles may not be transferred from the free list to the dutiable list or vice versa

By the end of 1939 agreements had been made with 21 countries including our important customers Canada, Great Britain France Brazil and Cuba In all of these agreements there were many reciprocal tariff reductions The agreements also contain the most favored nation clause that is, for example any tariff reductions granted in the treaty with Canada are also granted to all other nations provided such nations are held not to discriminate unfairly against American products For such discrimination for a time Australia and Germany were denied most favored nation treatment Later Australia was held to have removed her discriminations and Germany alone did not receive the benefits of treaty tariff reductions In the years after the negotiation of the reciprocal trade treaties there was an appreciable increase in our foreign trade How much this was due to the treaties and how much to a world wide recovery from the depression low it is impossible to say Certainly it is true that the percentage increases in trade were greatest with those countries with which treaties were in operation The Second World War has to a large extent checked the normal flow of foreign trade, and further negotiation of reciprocal treaties is in abeyance

Mechanism of International Payments

There is only one important difference between the settlement of international accounts and the settlement of domestic accounts—a difference in currencies An American exporter to France wishes payment in dollars and the French importer must arrange to transfer his francs into dollars The English exporter to the United States wishes payment in pounds and the American importer must arrange to transfer dollars into pounds These transfers are made in the foreign exchange markets which exist in all large financial centers These are not organized markets like the New York Stock Exchange but consist of the banks discount houses, and other firms who specialize in foreign exchange transactions

Just as in the settlement of domestic transactions the initiative in the settlement of foreign claims may be taken by either the exporter or the importer Let us suppose first that the initiative is taken by an American exporter who has sold cotton to an English textile factory The exporter will draw a draft or bill of exchange for the amount of the shipment Such bills are usually time bills that is not payable until 30 60 or 90 days after acceptance by the importer To the bill of exchange the exporter usually attaches the bill of lading and the insurance certificate and the documented bill is then sold to, let us say a New York bank If this is a 60 day bill, the New York bank will discount it at the current interest rate paying the exporter the discounted value of the bill The New York bank now forwards the bill to its correspondent bank in London which presents it for acceptance by the English firm on which it was drawn This firm now receives legal title to the cotton and the bill becomes a trade acceptance The London correspondent bank will have been authorized by the New York bank either to hold the accepted bill until it reaches maturity, or to sell it in the English discount market If the first course is followed, at the maturity of the bill its face value in pounds will be paid into the account of the New York bank at its London correspondent If the bill is sold in the discount market the New York bank loses the interest on the bill but the discounted pound value is immediately added to its account in London In either case, the New York bank has paid out dollars in New York and has collected pounds in London causing a decrease in its assets in New York and an increase in London

If the initiative in making payment is taken by the English cotton importer the usual procedure is for him to obtain from his London bank a commercial letter of credit for the amount of the shipment This letter authorizes the American exporter or his New York bank to draw a bill of exchange on the London bank for the designated amount The New York bank credits the exporter with the amount of the shipment and sends the bill of exchange to its London correspondent for collection from the London bank that had issued the letter of credit If the bill of exchange is a

sight bill it will be paid immediately If it is a time bill the London bank will accept it and the London correspondent of the New York bank can either hold it until it reaches maturity or sell it in the London discount market The London bank which issued the letter of credit collects from the English importer The result of this transaction is the same as that in the case described earlier The New York bank has paid out funds in New York these funds to the amount in question have been added to its London account

In both cases an American firm is exporting to an English firm necessitating a demand for dollars by the English importer and causing a shifting of the New York bank s funds from New York to London If these one sided transactions continued indefinitely the New York bank would eventually find all of its funds in London But of course at the same time that American firms are selling claims on English firms English firms are selling claims on American firms to London banks Just in the same way that banks clear checks against each other in the United States these foreign bills of exchange are balanced against each other The English exporters sell their bills in the London foreign exchange market and these bills are collected from the American importers by the New York banks In the main what is actually happening is that through the use of banking facilities American importers are paying American exporters and English importers are paying English exporters Actual cash would only move from one country to another to settle balances just as is true in the domestic clearance of checks among banks Moreover cash will not necessarily move just because for example, the claims of Americans against English firms may be in excess of the claims of English against American firms The claims of several countries against each other may be cleared so that little cash movement among any of them may be necessary For example in most years the United States buys more from Brazil than Brazil does from us Brazil s purchases from England exceed her sales to that country and England s imports from the United States are greater than her exports to us Through a system of triangular clearances formerly operated primarily in the London foreign exchange market the necessity for cash shipments from the United States to Brazil from Brazil to England and then from England to the United States is largely obviated A fuller discussion of cash movements between countries will appear in a later section

It is well for the beginning student of foreign exchange to consider such transactions from the standpoint of one country Transactions that call for payments by Americans to England create demands in New York for pounds in England they represent a supply of dollars Transactions which give Americans claims against England furnish a supply of pound bills in New York, in England they represent a demand for dollars But to simplify matters a list of items that cause a supply of and a demand

for foreign exchange in New York will be given From the foreigner s point of view the listing of the items would be reversed

The following items give rise to claims by Americans against foreigners and thus to a supply of foreign bills of exchange in the United States

(1) Exports of commodities including gold and silver
(2) Services performed for foreigners by American shipping companies insurance companies banks and the like
(3) Expenditures by foreign tourists in the United States
(4) Sale of American securities to foreigners and loans by foreigners to Americans
(5) Interest and dividends paid by foreign firms to Americans and the repayment of loans previously made by Americans to foreigners
(6) Gifts by foreigners to Americans

The following items necessitate payments by Americans to foreigners and therefore create a demand in the United States for foreign bills of exchange

(1) Imports of commodities including gold and silver
(2) Payments for services performed by foreign shipping companies in surance companies banks and the like
(3) Expenditures by American tourists in foreign countries
(4) American purchases of securities from foreigners and loans by people of the United States to firms and residents of foreign countries
(5) Interest and dividends paid by Americans to foreigners and the repay ment of foreign loans by Americans,
(6) Gifts by Americans to foreigners

The relative supply of and demand for bills of exchange on a particular country arising from the above named items determine the market ex change rate of the dollar in respect to the currency of that country If for example at a certain period the demand for pound bills is in excess of the supply of pound bills the pound rate will tend to rise If the supply of pound bills is in excess of the demand for them the pound rate will tend to fall The extent to which the rate can rise or fall depends upon the monetary standards of the countries concerned and upon the controls of foreign exchange instituted by the several governments

Exchange Rates Between Two Countries on the Gold Standard

The par of exchange between two countries on the gold standard is de termined by the relative amounts of gold contained in the standard mone tary units of the two countries For example for many years the British pound contained 113 grains of fine gold and the American dollar 23 22 grains The par rate between these two currencies was obtained by divid ing 113 by 3 22 which gave a quotient of 4 8665 Therefore when the exchange rate was at par £1 was equal to $4 8665

As has been seen however the day to day market exchange rate fluctuates in accordance with the demand for and supply of bills of exchange If during a certain period American purchases of British goods exceeded British purchases of our goods if American tourists were making heavy expenditures in England if Americans were making large loans to British firms or if there was a large demand for British pounds arising from any of the sources listed earlier there would be a tendency for the pound rate to rise above the par of $4 8665 If on the other hand our exports to England exceeded our imports from England if English visitors were spending large sums in the United States if the English were lending large sums to the United States or if for any of the other reasons named above American credits to England exceeded our debits to that country there would be a relative excess of supply of pound bills in New York and their rate would tend to fall below the par of $4 8665

If there had been no cost attached to the shipment of gold between England and the United States the market rate could not have varied from the par rate Americans owing funds in England would have refused to pay more than $4 8665 for a pound bill if they could have exchanged $4 8665 for 113 grains of gold and have sent the gold to England without cost and likewise Americans holding claims against England would have refused to sell these claims for less than $4 8665 per pound if it had been possible to ship 113 grains of gold to the United States without cost But shipment of gold across the Atlantic involves transportation and insurance charges and loss of interest while the gold is in transit These costs varied somewhat from time to time but let us assume that they amounted to 3 cents per pound sterling As long as the market rate for the pound was less than $4 8965 it paid Americans desiring pounds to buy bills of exchange rather than to ship gold in settlement of their accounts and as long as the rate was above $4 8365 it paid Americans with claims on England to sell bills of exchange rather than to have gold shipped from England From the standpoint of the United States the price $4 8965 was the gold export point and the price $4 8365 the gold import point As long as the market rate remained within these limits there would be no flow of gold between the countries But if the rate went above $4 8965 it was cheaper for Americans to ship gold to England than to meet their obligations by the purchase of bills if the rate went below $4 8365 it was cheaper for Americans to collect their claims in the form of gold shipped from England than through the sale of bills of exchange To a resident of England, of course the gold import and export points were just the reverse Gold would flow into England if the market rate was over $4 8965 and would flow from England if the rate was less than $4 8365

Shipment of gold was arranged for by the banking institutions of the two countries rather than by individuals and firms seeking to make payments in the foreign country It has been shown earlier that the foreign

exchange dealers principally banks make purchases and sales of foreign bills as they arise out of various types of transactions It was also shown that as American exporters sell their supply of bills of exchange to New York banks and the New York banks through their London correspondents collect from the English importers that the New York banks find their funds depleted in New York and expanded in London In order to counteract this they become willing to pay less for pound bills in New York and to sell them for less than par Under the gold standard however this lessening of the market value of pound bills could continue no farther than the gold import point for it would then pay the bank to meet the expenses of gold shipments rather than to sell bills at a lower rate When importers purchase pound bills from New York banks these banks have made commitments to pay the English exporters If the demand for pound bills in New York is in excess of their supply the New York banks funds in London tend to become too small to pay the English exporters The New York banks then will only sell pound bills at a higher price and at the same time they will be willing to pay a higher price for the supply of pound bills offered by American exporters But under the gold standard the upper limit to this higher price was the gold export point, $4 8965 Above this point it was cheaper for the New York banks to ship gold to England

Between countries on gold standards there are certain so called automatic checks that tend to prevent the excess flow of payments from continuing indefinitely in one direction Take the period when both England and the United States were on the gold standard and suppose that the demand for pound bills in New York exceeded their supply The market rate for pound bills would tend to rise above the par rate and let us say it reached $4 89 At this point English goods and English services became more expensive to American buyers while American goods and services became less expensive to English buyers This shift in the relative costliness of the goods and services of the two countries tended to cause Americans to curtail their purchases from England and to cause the English to increase their expenditures in the United States This shift in turn would cause the market rate of pound bills to fall from the former rate of $4 89

But the intensity of the American demand for English goods might be so great and the intensity of the English demand for American goods so small that the higher exchange rate would not check the direction of the excess flow of payments The market rate for pound bills might continue to rise and go above the American gold export point If the rate went above $4 8965 it was cheaper to ship gold to England than to buy pound bills The exported gold went from American banks to English banks, thereby decreasing bank reserves in this country and increasing them in England The lessening of bank reserves would tend to cause discount

rates to be raised in the United States and the increase in English bank reserves would tend to lower discount rates in that country To secure the advantages of the higher discount rates English lenders would invest their funds in the American short term loan market thus causing an increased supply of pound bills in New York This of course would be a check on the upward swing of the pound rate

Moreover the flow of gold from the United States to England would introduce an even more important check to the excess balance of payments As our discussion of the quantity theory of money in a previous chapter has shown an increase in the quantity of gold tends to increase M and M the volume of money and of credit in circulation and their increase tends to cause the price level to rise Conversely a decrease in the gold supply tends to cause a falling price level Therefore the export of gold from the United States to England would tend to cause prices to fall in this country and to rise in England This shift in the price levels of the two countries would make England a poorer place in which to buy and the United States a better place and thus there would be a tendency for the excess American purchases in England to cease

Within limits these automatic checks worked reasonably well to maintain a proper balance between the purchases and sales of gold standard countries and to prevent one country from losing all its gold But in foreign exchange as in other spheres of economic activity governmental and banking officials at times deemed it necessary to institute controls The central bank rate was sometimes raised before gold started leaving a country rather than waiting for the diminution of the gold supply to cause it to be raised automatically Or other direct measures might be instituted for raising or lowering the internal price level such as open market operations by the central banks changing bank reserve requirements or a policy of gold sterilization which would affect the flow of international trade Therefore while exchange between countries on gold standards operated relatively automatically through the demand for and supply of bills of exchange, nevertheless it was subject to direction and control and this was especially true after 1914 for the few countries that operated on a full gold standard

Exchange Between Countries on Inconvertible Paper Standards

During many of the years since 1914 most of the various currency systems have not been based on gold During the War of 1914 1918 all the belligerent nations except the United States abandoned the gold standard In the period of the twenties most of these nations returned to the gold standard but in most cases in a greatly modified form As was explained in an earlier chapter in many countries the gold bullion standard superseded the old gold coin standard Moreover, in many countries the gold content of the standard currency unit was greatly reduced as for example

in France and Italy Alone of the major countries England maintained the former gold content of its monetary unit when it adopted the gold bullion standard in 1925 The general return to gold however was not long continued The depression beginning in 1929 finally drove all the leading countries from the gold standard and nowhere today is the pre 1914 gold standard in operation In the United States the internal standard is paper but there is no difficulty in buying gold at the rate of $35 an ounce to meet foreign commitments In some countries there has been little difficulty connected with importing and exporting gold in the settlement of foreign balances but instead of a fixed price for gold as in the United States its price has fluctuated as has that for other commodities in relation to the demand for and supply of gold In still other countries gold cannot be secured for the settlement of foreign balances Under these varying currency conditions foreign exchange and foreign trade are greatly handicapped but trade has still continued although often in much reduced volume Under these conditions what determines exchange rates between currencies?

First let us consider the exchange rate between a true gold standard country and a country on an inconvertible standard but with no restrictions on the import or export of gold The rate between the currencies of the two countries is still set by the price of gold In the gold standard country this price is fixed by the gold content of the standard currency unit In the other country it is the market price of gold which is of course higher in terms of the country s paper money than was its fixed price when the country was on the gold standard For example the former fixed price of gold in England was £3 17s 10½d per ounce Let us assume that in terms of paper pounds the price became £4 17s 10½d per ounce English importers must secure dollar exchange to meet their obligations just as formerly But formerly if the premium on the dollar became more than 3 cents a pound it was cheaper to ship gold to the United States than to buy dollar bills at the higher rate Now however Englishmen would find it cheaper to pay a premium of more than 25% on dollar exchange rather than to buy and export gold In other words the market rate of exchange between the pound and the dollar can fall to something like $3 60 before the gold export point in England will have been reached Moreover there is no stability to the English gold export and import points They fluctuate as the English price of gold varies Within these fluctuating gold points the market rate of exchange between the pound and the dollar will vary in accordance with the relative demand for and supply of the bills of exchange drawn on the two countries

Now let us take the case of exchange between a gold standard country and a country on an inconvertible paper standard which restricts the free export and import of gold Here the exchange rate can only be determined

by the relative demand for and supply of bills of exchange drawn on the two countries Unquestionably the rate will be unfavorable to the paper standard country for the probable reason for its leaving gold was that its obligations to other countries had become so great that gold payments could not be continued Furthermore the paper money prices will tend to be higher than the former gold prices probably considerably higher and as the discussion of the purchasing power parity theory in the next paragraph will show this causes the value of the paper money unit to fall in relation to a gold standard unit

Finally let us consider the exchange rate between two countries on inconvertible paper standards both of which restrict gold imports and exports Since such paper money has no fixed gold value there can be no such definite par of exchange as exists between two gold standard countries But there is a kind of parity between the two paper currencies called purchasing power parity which is determined by the relative internal purchasing power of the two units Suppose that both England and the United States have left the gold standard but that prices in the two countries have remained at their former levels The par rate of exchange would still be $4 8665 for if a paper pound will buy in England 4 8665 times as much as a dollar will buy in the United States those demanding and supplying bills of exchange will still bid approximately $4 8665 for a pound If the rate fell much below $4 8665 English goods would become relatively cheap to American buyers and American goods relatively dear to English buyers Increased purchases of English goods would increase the demand for pound bills and decreased purchases of American goods would curtail the supply of pound bills The result would be a tendency for the market rate to return toward $4 8665—purchasing power parity

But there is no such fixity to purchasing power parity as there is to the parity between the currency units of gold standard countries Reverting to our illustration suppose that paper pound prices in England become twice as high as paper dollar prices in the United States The new purchasing power parity would be $2 43 for the pound is now relatively only half as valuable as before and Americans in bidding for pound exchange would only be willing to pay half as many dollars for it Since there is a tendency to wide variations in the price levels of countries on paper standards there is thus a tendency to wide fluctuations in purchasing power parity

It was shown earlier that there are certain so called automatic checks which tend to restore equilibrium in the balances of payments between countries on the gold standard These are (1) the exchange rate itself (2) the results of the flow of gold The second of these of course does not operate or at least to but limited extent between paper standard countries The restoration of equilibrium is almost wholly dependent on fluctuations in the exchange rate If under our illustration, American pay

ments due England exceed those owed us by England the pound rate will rise This higher rate makes English goods more expensive and American goods cheaper Americans will tend to buy less in England and the English more in the United States and equilibrium will tend to be restored

It is true however that there is not the close connection between the internal price levels and the exchange rates that the purchasing power parity theory implies When a currency is depreciating in value there is a tendency for it to fall more rapidly in the foreign exchanges than in the home market In other words the rise in the domestic price level lags behind the fall of the currency s value in foreign exchange This is because such cost items as interest rent and wages are rather inflexible while fluctuations in foreign exchange rates are very responsive to even anticipated changes in business and monetary conditions It is because of this lag that countries with a depreciating currency have a temporary advantage in sales to foreign markets If the English pound is falling in relation to the dollar and there is a lag in the rise of English prices, Americans will buy more English goods During the inflationary period in Europe after the First World War many Americans bought goods from Germany Austria and other countries at ridiculously low dollar prices When and if the rise in internal prices catches up with the fall of the value of the currency in the foreign exchanges the country with the depreciated currency no longer has an advantage in foreign sales

Exchange Controls

It has been shown earlier in this chapter that even in the heydey of the gold standard government and banking officials were not always content to wait for the operation of the so called automatic forces to restore equilibrium in international exchange Discount rates were manipulated and open market operations engaged in to protect ' artificially the gold supplies of the various countries and at other times, as in the United States during the 1920s incoming supplies of gold were at least partially sterilized to prevent the rise in prices which the automatic forces supposedly would have brought about But while the exchanges were far from being uncontrolled when the important countries were on the gold standard, nevertheless such controls were minor as compared with those introduced in most countries during the First World War and in the period since 1929—periods when most countries were on paper standards

The pegging' of the pound at $4 76 between 1916 and 1919 is an interesting example of exchange controls during the First World War From the beginning of the War England made heavy purchases of war supplies in the United States These were paid for in part by the sale of British owned American securities and by gold shipments, but these proved insufficient and the pound rate dropped greatly below par In 1916 an ar

rangement was made with J P Morgan and Company by which that firm agreed to buy sufficient pounds so that its rate would be maintained at $4 76 This of course meant that the House of Morgan was lending large sums to the British government After the entry of the United States into the War in 1917 the pegging process continued with the funds now being supplied by the United States government Pegging stopped in 1919 and the pound fluctuated considerably below $4 76 until England returned to the gold standard in 1925

Since the World War and more particularly since 1929 international exchange and trade controls have grown at an ever increasing rate To high tariff barriers have been added quota restrictions on imports and the establishment of import monopolies or the requirement of import licenses Currency depreciation has been engaged in to expand exports and such exchange controls as exchange allotments and blocked exchange which can only be used in the blocking country have been instituted to increase exports and either to curtail imports or to direct purchases abroad into the desired channels The most extensive of these controls are naturally found in communistic Soviet Russia The Soviet currency is not dealt in on the foreign exchanges and all purchases and sales are made in the currency of the country with which the Soviet Union is doing business Decisions as to what shall be bought and sold abroad are made by the state planning agencies and these decisions are executed by state officials

Until the outbreak of war in September 1939 of the countries supposedly maintaining private enterprise fascist Germany Italy and Japan had introduced the most drastic controls of foreign exchange and trade In Germany for example, a certificate had to be obtained from one of 27 Control Boards each dealing with different types of goods before any order could be placed abroad The German currency was also manipulated through the use of various kinds of blocked marks for the purpose of increasing German exports Foreigners having claims against Germany were usually paid in these marks which could only be used to buy German goods or services To complicate matters even more under that master magician Dr Schacht the value of these blocked marks in the purchase of German goods varied with almost every transaction One observer has suggested that there were no fewer than 237 different values to the then existing marks [1]

Although their controls were not nearly so severe as those of countries like Germany Italy and Japan, nevertheless during the worst of the depression period of the 1930s the non fascist countries also found it impossible or undesirable to continue uncontrolled foreign exchange payments Since most of these countries were on paper standards the value of their currencies in the exchange markets tended to fluctuate rather widely To

[1] S H Roberts *The House That Hitler Built* (Harper & Brothers New York 1938) p 156

curb these fluctuations England and France established exchange stabilization funds If for example, the English authorities decided that the foreign exchange value of the pound was falling to too low a level their stabilization fund was used to buy pounds if it was considered that the value of the pound was too high the administrators of the fund sold pounds After the devaluation of the American dollar in 1934 our government also established a stabilization fund with the profits gained from devaluation This fund was used to stabilize the value of the dollar in its exchange relations with foreign currencies and also in the attempted control of our internal price level In 1936 the United States England and France entered into an agreement to cooperate in the stabilization of their currencies Other nations were invited to participate in the agreement and Switzerland the Netherlands and Belgium joined Under this agreement the stabilization funds of the several countries were used in the purchase and sale of exchange in the attempt to maintain the value of the currencies concerned at approximately the levels sought by the participating countries This agreement represented an attempt to expand foreign trade through lessening currency uncertainties wild exchange fluctuations and general economic disorder But it was also another step away from the old semi automatic system of foreign exchange under which the rates were determined in a free market by the relative demand for and supply of the various currencies

With the outbreak of war in September 1939 countries whose trade and exchange restrictions had been mild compared with those of the fascist countries felt it necessary to introduce somewhat similar measures for the purpose of utilizing their limited supplies of foreign exchange in the purchase of essential military materials For example at the beginning of the war the British government inaugurated stringent exchange controls and fixed official buying and selling rates for the dollar For a time a limited free market for pounds in which exchange arising from certain types of transactions could be bought and sold existed alongside the official market But by mid summer 1940 the free market was practically abolished and future transactions in exchange were to be carried on almost entirely under the auspices of the official authorities and at the official rates of $4 025 paid for pound exchange and $4 035 as the selling price Canada likewise has established a Foreign Exchange Board which has wide powers over dealings in foreign exchange by Canadians, the licensing of imports and exports of all kinds including money and securities and the fixing of rates at which exchange may be bought and sold

At present the American dollar is the only currency for which there is a relatively free market All the other countries belligerent and non belligerent alike have such drastic controls over the purchase and sale of their currencies that their exchange rates are almost altogether determined by administrative action rather than in a free market This neces

sarily greatly hampers foreign trade tending to make it almost direct barter between two countries rather than being of the multi lateral type in which a country deals with any and all countries according to where the advantage in trade seems to be greatest It is impossible to say whether this controlled trade and exchange will continue after the war But it seems likely that just as in all countries there has been increasing governmental regulation of all internal economic activities likewise greater controls in international matters will exist than in the pre war days

PART VI

Public Finance

CHAPTER 21

GOVERNMENT EXPENDITURES

The problems of public finance could be solved with gratifying ease if today it were possible to dispose of these matters with the facility that marked the treatment they received at the hands of the French economist Jean B Say some hundred years ago He reduced what at best is a highly complicated field of inquiry to proportions of fetching simplicity and proceeded to dismiss the subject with what has since become an historic generalization The very best of all plans of finance is to spend little and the very best of all taxes is that which is least in amount In spite of Say s pronouncement society in the intervening years has evidenced an unflattering disregard for his opinion The tendency for both expenditures and taxes to increase is too deeply rooted in the culture of western industrialized nations to be set aside by any single voice

Government in Action [1]

If some catastrophic upheaval were suddenly to destroy all governmental units in the United States the most hardened critic of government would be shocked into a belated realization of the extent to which he depended upon these institutions So habituated do many people become to the services supplied by the government that they unthinkingly take them for granted It would be exceedingly difficult for anyone to spend the shortest period of time without in some way making use directly or indirectly of a service supplied by government As you read this page stop for a moment and ask yourself what services rendered by the government make it possible for me to be where I am doing what I am

Professor Paul Studenski has grouped governmental expenditures on the basis of the services performed [2]

1 Social and cultural services which aim at the improvement of the quality of social life such as (a) cultural improvement (schools libraries museums) (b) improvement of public health (child hygiene milk and food inspection prevention of communicable and occupational disease) (c) sanitation (sewage street cleaning removal of waste) (d) recreation (parks playgrounds) (e) social welfare (care of the aged orphans mental defectives sick and poor correction of criminals social insurance for old age

[1] See Table 1 and Chart 1

[2] W E Spahr (ed) *Economic Principles and Problems* rev ed (Farrar & Rinehart New York 1936) pp 593 594

TABLE I

FEDERAL AND ESTIMATED STATE AND LOCAL GENERAL GOVERNMENT EXPENDITURES FISCAL YEAR ENDING IN 1938[3]

(In Millions of Dollars)

	Function	Federal	State	Local	Total Amount	Total Percentage
1	Education	17	248	2 148	2 413	13 3
2	Highways and streets	17	842	811	1 670	9 2
3	Agriculture resources	973	98	5	1 076	5 9
4	National defense	1 608	14	—	1 622	8 9
5	Police and other protection	44	138	566	748	4 1
6	Relief welfare and social security	1 922	591	572	3 085	17 0
7	Net addition to social sec reserves	448	557	—	1 005	5 5
8	Health and hospitals	20	279	272	571	3 1
9	Interest	926	121	592	1 639	9 0
10	All other	846	612	2 183	3 641	20 0
11	Total expenditures	6 821	3 500	7 149	17 470	
12	Debt retirement	65	123	541	729	4 0
13	Total disbursement	6 886	3 623	7 690	18 199	100 0

PERCENTAGE DISTRIBUTION OF EXPENDITURES 1938

	Function	Federal	State	Local	Total
1	Education	2 3	18 8	23 1	13 3
2	Highways and streets	3 4	20 7	8 3	9 2
3	Agriculture resources	13 0	1 7	0 05	5 9
4	National defense	20 9	0 3	—	8 9
5	Police and other protection	0 6	3 1	9 2	4 1
6	Relief welfare social security	28 4	14 6	4 3	17 0
7	Net addition to soc sec reserves	6 4	11 8	—	5 5
8	Health and hospitals	0 5	6 2	4 3	3 1
9	Interest	12 0	2 8	9 6	9 0
10	All others	11 7	16 9	32 5	20 0
11	Debt retirement	0 8	3 1	8 6	4 0
	Total	100 0	100 0	100 0	100 0

[3] From D Anderson *Taxation and Recovery* (Temporary National Economic Committee Washington 1940)

unemployment industrial accidents and other contingencies retirement of public employees)

2 Constructive economic services which seek to facilitate and improve economic activity such as (a) aid to industry commerce and agriculture (coining of money and provision for currency registration of patents and copyrights tariff protection conservation and development of natural resources including reclamation reforestation flood prevention construction and maintenance of highways bridges and waterways subsidization of industries requiring aid collection and distribution of information scientific research) (b) regulation of economic activity (regulation of public utilities railroads banks industrial combinations and other busines factory inspection and administration of other labor laws administration of building and zoning laws)

3 Services of governmentally owned enterprises (post offices railroads mines banks forests water supplies docks street railways and subways ferries toll bridges toll canals markets electric light and gas plants power plants municipal housing)

4 Preparation for war and payment for its consequences (maintenance of an army and navy reparations veterans pensions hospitalization and other benefits and above all interest on and redemption of the war debt

5 Internal protection of life and property (police and fire pro ection militia administration of justice)

6 General government and miscellaneous services (maintenance of the chief executive and the legislature administration of finance administration of elections)

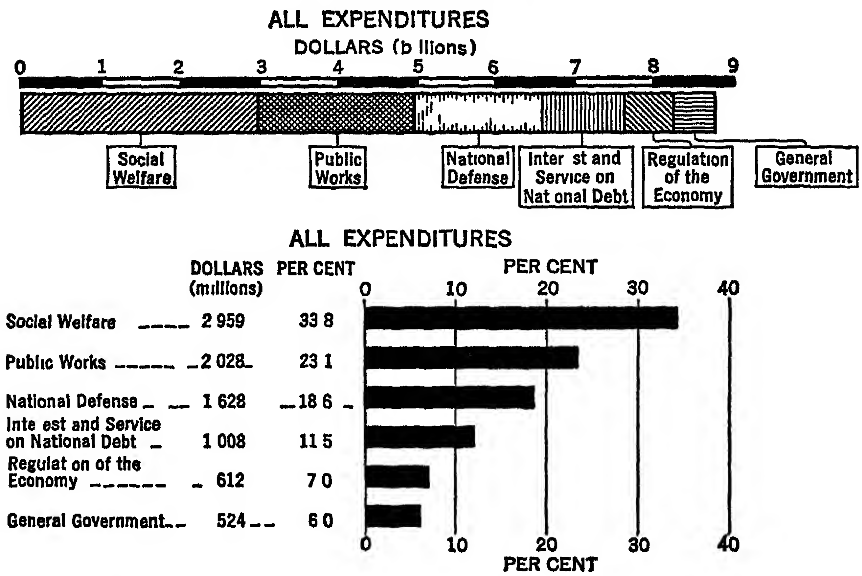
Trend of Government Expenditures

One student of government finance Adolph Wagner after an exhaustive inquiry into the fiscal experience of European nations concluded that governments participation in the total economy had constantly increased and would continue to do so until ultimately state socialism resulted This he believed to be due to the fact that governments performed old functions more intensively and efficiently and were constantly assuming new functions While many disagree with Wagner s final conclusion—the inevitability of state socialism—there is a unanimity of agreement unusual among students of public finance on the accuracy of his general thesis of increasing expenditures

In 1938 total government expenditures in the United States amounted to $18 199 000 000 This sum was divided among the various units of government as follows states $3 623 000 000 local including cities townships counties school districts, etc , $7 690 000 000 federal $6 886 000 000 Approximately 23% of our national income is now being spent through government channels Increase in expenditures has been persistent although advancing more rapidly at some periods than at others The sharp increases that in the past have marked periods of war and the customary post war retrenchment programs have tended to ob

scure the steadiness of this upward movement On occasions attempts are made to offset this trend if not to reverse it Although such endeavors have at times enjoyed a degree of success in the end their ephemeral character becomes most evident So clearly marked is the general trend that the conclusions reached by Wagner can as well be applied to the United States as to Europe The more information that is accumulated the more certain it appears that this tendency for governmental expenditures to increase is inherent in modern civilization

CHART 1 [4]
EXPENDITURES OF THE UNITED STATES GOVERNMENT
(By Function Fiscal Year Ending June 30 1939)



Measurement of Increase of Public Expenditures

Caution must constantly be exercised when treating statistical data in the field of public finance if the information is not in the end to prove misleading It is not uncommon for the proponents of some line of action to resort to fiscal legerdemain in their endeavor to persuade others to their point of view Comparisons based upon absolute amounts of money are ofttimes most deceptive A loose handling of figures frequently results in the drawing of inferences which upon a more thorough analysis are found to be untenable Before any conclusions are accepted as being neces sarily correct merely because the supporting arguments have been well interlarded with an imposing array of statistical material, remember that what seems to be and what is quite often are different

[4] From D Anderson *Taxation and Recovery* monograph submitted to the Temporary National Economic Committee 1940

One precautionary measure is to ascertain whether the data are comparable A very serious difficulty can be obviated if unlike things even though possessing a high degree of superficial similarity are recognized as such The failure to account for fluctuations in the value of money bogs down many a fiscal discussion in a morass of confusion [5] If the government continues its customary functions in spite of a fall in the value of money no choice remains but to increase its revenues Thus although governmental expenditures measured in absolute amounts have increased no new functions have been assumed nor have any of the older services been extended Therefore if comparisons are at least to approximate accuracy changes in the value of money must be allowed for when discussing governmental expenditures

Changes in the manner in which the individual pays his obligations to his government offer an additional illustration of these seeming increases in governmental expenditures At one time the customary method of maintaining roads was for the government to secure its labor supply by compelling the citizen to give to the state so many days of labor each year without recompense So long as the individual s contribution was in this form it was not reflected as a monetary transaction in the government s budget However when this system of payments in kind was abandoned in favor of payments in money, the budget mirrored the change by exhibiting an increase in fiscal operations The fact that under the altered set of conditions budgetary money transactions increased did not necessarily mean as many assumed that the government had expanded its activities Rather the expanded outlays recorded by the budget was simply the financial method of recognizing this change which had taken place

Furthermore accounting procedure may be so reorganized as to include in the budget certain items as expenditures which were formerly omitted When the fee system was in vogue these payments not passing through the treasury did not appear in the fiscal record as governmental expenditures When this system was replaced by that of directly paying office holders an annual wage the expenditures of the state appeared to have increased What in fact has happened is that instead of the fee being paid directly by the individual to the office holder it now takes a more circuitous route before arriving at its destination It is paid by the citizen to the government as a tax and then the government from these collections pays the employees wages The budget as a consequence of this change in accounting method records increased receipts and expenditures

Yet even though allowances are made for all these limiting factors real per capita expenditures have increased This fact of itself is of limited significance but it does however establish the expansion which has

[5] Total governmental expenditures in 1928 measured in current dollars amounted to $12 609 billions expressed in 1913 dollars this amount would have been $9 006 billions

been occurring in governmental activities[6] But whether this expansion is good or bad cannot be determined on this basis alone For while the payment of taxes imposes a burden the receiving of governmental services bestows a benefit The fundamental problem is whether the benefits received justify the burden of taxation And it is at this point that opinions differ most widely One tends to be more sensitive of the burden imposed by taxation than he is of the benefits which these taxes make possible

Unfortunately the complexity of the problem makes any simple formula unacceptable as an entirely satisfactory measure of a tax burden What would constitute an unpardonably lavish expenditure for an impoverished nation may well be carried without strain by one of greater wealth The burdensomeness of taxation depends too in part upon the manner in which the load is distributed If the distribution of taxes bears a favorable relationship to the distribution of personal income the weight of the load is minimized Nor should the services which are received from the government be forgotten But since in the final analysis taxes must be paid from total national income, the most acceptable formula for measuring both the burden of taxation and the increase in expenditures is that which expresses each as a percentage of the national income

Scope of Government Action

There are some who resolve all of the problems of public finance by holding that the state is but a huge sink into which astronomical sums are poured never again to be seen That the building of a highway the protection of property, the maintenance of consulates are governmental activities satisfying wants is forgotten by them People have wants and it is their wish to have them satisfied as completely as lies within their power In the course of time it becomes evident that some wants can better be satisfied through one set of institutions than another The same person who gratifies certain of his desires through individual action may at the same time be satisfying other wants by collaborating in some form of group action To illustrate he may buy his food at the corner grocery store hold membership in a church own shares in a cooperative store When it becomes a matter of protecting life and property of building and maintaining highways, of providing elementary educational facilities, he ordinarily combines with others to provide for these goods and services The institution through which he satisfies these wants is the state Hence the state can be viewed as the people acting collectively through designated governmental agencies for the purpose of satisfying certain common wants This statement is not intended to imply that there are no other concepts of the state it is offered merely as a working definition for the purpose at hand

[6] Total governmental expenditures per capita were as follows 1890 $13 56 1913 $30 24 1923 $91 88 1928 $105 20 1936 $132 73

More should not be read into the above statement than is intended Even though it is agreed that the state is the people acting collectively it should be borne in mind that the people voice their desires through their elected representatives Therefore whether the expenditures made by the state are those most wanted by the people depends upon how well the representatives reflect the wishes of their constituents There is reason to believe that that somewhat elusive thing called the will of the people is often a less decisive factor in influencing legislatures than the insistent and ofttimes exceedingly vocal demands of well organized competently led pressure groups

A nice weighing of alternatives by legislators in an atmosphere of academic objectivity is forced to give way before the continuous struggle of groups each striving to obtain its end It becomes less a question of which society needs the more say schools or roads than a problem of which of these two possible expenditures can marshall the more powerful political backing What is best for society may definitely be subordinated to what is politically expedient at the time Men whose political life depends upon reelection are keenly aware of the desires of those groups which can most effectively make known their wishes In short it is not only the possession of power but the ability to use it that counts in the legislative arena

The extent and nature of a government s participation in the community is decided principally by the social philosophy which permeates the thinking of the politically dominant group in the community If this group agrees that the interests of society as interpreted by them are best served by perpetuating the competitive system then government functions are perforce narrowly circumscribed The proponents of the competitive way are convinced that social well being is maximized only when enlightened self interest is given free rein Advocates of laissez faire approach governmental expenditures with a predetermined opinion in opposition to an extension in the scope of governmental functions One adhering rigidly to this school of thought would not differ markedly from Adam Smith in his enumeration of those functions permissible to governments namely protection of the citizen and his property from outside aggression and the maintenance internally of law and order Under this concept the state s primary function is to protect property the acceptance of any new function by the government would depend upon whether or not it assured business freedom of action

In contrast to the attitude presented above is that associated with what is termed totalitarianism The proponents of totalitarianism claim that competition in the market place and democracy at the polls are twin evils destructive to national progress The individual is submerged in the whole the national personality predominates Economic well being may be subordinated to other and in the opinion of the state more important

ends A pure racial stock a powerful military machine may be held far more worthwhile objectives for which to strive than the increasing of con sumers goods and services

In order that the authority and centralized control necessary to a totali tarian system be present the state is conceived of as a separate entity as an organism distinct from the people over whom it exercises control It is omnipotent and omniscient Grant the premises upon which such a system is founded then a constant increase in the scope of governmental func tions is to be anticipated

In the United States is there any fundamental philosophy relative to this question of the proper scope of governmental functions to which the bulk of people adhere? Is there in this country a predetermined opinion either in favor of or in opposition to an increase in governmental activity? Or is it that this entire matter of the proper scope of government function is but a question of some people wanting some things and other people wanting other things and the government yielding to those possessing the greatest power? Although it is true that the United States has moved a great distance from the area fixed by Adam Smith and John S Mill as constituting the proper scope of governmental action there continue to be many people who view this movement with alarm[7] There is a fear that the centralization of control which the extension in the scope of the federal government s activities entails will in the end prove economically and politically disastrous Is there any method available which one could use to judge whether a government should or should not accept some new function?

The Theory of Maximum Social Advantage

Mr Hugh Dalton an economist of repute a member of the British Labor Party and at present an active member of the British govern ment has sought to answer this question of what constitutes the proper scope of government action by proposing the Theory of Maximum Social Advantage This theory states that if the assumption of some new func tion by the government yields the people greater benefits than could have been attained by allowing the funds to be spent privately by the taxpayer then it is socially proper for such action to be taken If the contrary be true then the new function should not be assumed The acceptance of this theory would free one from predetermined opinions in favor of or in opposition to an extension in the scope of governmental functions It is assumed that a sincere endeavor will be made to weigh each new function contemplated in light of all the relevant information obtainable and that final decisions will be made on the basis of this information This process of evaluation recognizes that conflicts are inevitable between interested groups with markedly different points of view and mutually exclusive

[7] *Fortune* The Fortune Forum of Executive Opinion Sept 1940 Dec 1940

objectives It assumes however that decisions will be made only after all affected parties have the opportunity of presenting their reasons for supporting a given line of action before the various legislative committees

It is easier to state this theory than to apply it The generalization is apt to blind one to the numerous difficulties involved in the actual process of weighing alternate expenditures It implies that in spite of the differences in motivation there is some set of criteria generally accepted by which the relative efficiency of industry and government can be gauged It assumes too that objectivity will mark the actions of the members of the legislative bodies and the influence of any particular group will not be sufficiently great to jeopardize the technique of weighing And finally since the beneficiaries of state expenditures may be a group other than that which pays the taxes this calculus of benefit and taxes becomes difficult of application

Transfer Expenditures

To the extent to which the government provides the funds requisite to meet its expenditures through taxation there results a transfer of purchasing power from the people to the state In some cases the purchasing power is returned to the people in the form in which it was taken The federal government spends approximately $1 000 000 000 annually to meet the interest on the national debt To the extent that these federal bonds are held within the country the purchasing power originally taken from the people as taxes is returned in the form of interest on the debt While the people paying the taxes may not be identically the same group which receives the interest nevertheless from the standpoint of society as a whole the total amount of privately controlled purchasing power has not been decreased by such a transaction Society still has as much money as it had prior to the transfer The quantity of goods and services produced in response to individual demands has not been decreased by this fiscal operation

Since only under the most exceptional circumstances would the individual paying the taxes receive an exactly equivalent amount in the form of interest even a pure transfer as explained above would affect the national economy It is probable that subsequent to the transfer some people would have more and others less purchasing power If this occurs and the probabilities favor such a result the volume and type of specific goods being produced will be affected To illustrate if the tax system were extremely graduated and if the bonds were held by the masses then money funds would be shifted from the well to do to the less fortunate If such a situation were conceivable the tendency would be for savings to decrease and expenditures for consumers' goods to increase Contrariwise if the bonds were owned by the more fortunate and the taxes were paid principally by low income receivers a condition which reflects ac

tuality more closely savings would most likely increase and expenditures for necessities decline

It is not intended here to trace through this type of transaction step by step nor to cover all the possible combinations of circumstances which might arise, but only to emphasize this transfer type of governmental expenditure It is of especial interest because the government acts merely as a transfer agent through whom funds taken from the people are returned to the people as purchasing power To reiterate this type of expenditure does not decrease the control over the economy exercised by individuals through their private expenditures Also it should indicate the necessity of separating this type of expenditure from others when investigating the growing participation of the state in the direction of economic activity

Exhaustive Expenditures

In contrast to the above there is another type of governmental expenditure one in which purchasing power having been taken from the people in the form of taxes is used by the government to purchase goods and services to satisfy the collective wants of the people This form of expenditure is called exhaustive to distinguish it from the pure transfer explained above Assume that a local government has decided to build a road Those materials such as cement, tar sand etc and that specialized labor necessary to road construction must be hired and purchased by the government that is resources are now being directed into certain channels by means of governmental expenditures rather than into others in response to private expenditures

The total amount of privately controlled purchasing power is reduced by the amount of the tax while at the same time the purchasing power of the government is increased by a similar amount Thus if the national government elects to increase its naval force by an additional battleship costing $90 000 000 it must secure this sum in order to defray the cost incurred in the construction of the ship The $90 000 000 is taken from the people through various taxes unless borrowing is resorted to, leaving them with just that much less purchasing power to be used privately In the case therefore of an exhaustive expenditure purchasing power is obtained by the government in order that resources can be solidified into goods destined to satisfy not the wants of individuals but the collective wants of the group

Economic Effects of Governmental Expenditures

Social well being depends, in part upon the production of goods and services in sufficient quantities and varieties to meet the wants of all the people Consequently, governmental expenditures can only be justified so long as they are productive Although this statement would secure general

affirmation, a difficulty would most surely arise as soon as an attempt was made to define productive And moreover, greater disagreement would be forthcoming when the term was applied to some particular expenditure

In private business a productive expenditure is one that yields a profitable monetary return This test however is inapplicable in the government economy for monetary gain is not the motivating force In government an expenditure is held to be productive if it succeeds in satisfying some collective want Hence a school building is a productive expenditure even though no money return results directly from its use The end to be striven for by any government is to avoid wasteful expenditures and inefficient use of resources To do a thing badly is no more to be tolerated in government work than in any other field of activity Too much is needed by too many people to condone waste and xtravagance either in public or private enterprise

There are areas in which it is most difficult to ascertain the productiveness of an expenditure Such an area is the field of armaments Fundamentally what is sought is protection against aggression The citizen desires assurance that he will not be molested as he pursues his routine affairs The threat of war does not create an environment conducive to normal business activity The major problem however is when do armaments pass that point necessary for adequate protection and become an unproductive use of resources?[8]

To the extent that our armed forces are but a unit in an international police force maintained for the purpose of allaying fears incident to international aggression the funds expended upon their maintenance are held to be productively employed But when protection degenerates into a competitive armaments race with each nation striving to outstrip all others by diverting a larger and larger percentage of its resources into this endeavor no nation gains Such expenditures are unproductive How much of an effective choice rests with any specific nation in this armaments race is a matter for speculation If any nation sets military might as its raison d etre little choice remains to its neighbor Either it accepts the challenge or is forced to accept a subordinate position in the family of nations

Today when many governments are under pressure to reduce appropriations for educational purposes and medical facilities it is a sad commentary upon human progress that it is found possible to appropriate an ever increasing percentage of the national income for arms Society at present, is so firmly impaled on the horns of this dilemma that little else remains but to regret that a more socially useful purpose for our resources seemingly can not be found

[8] A conservative estimate is that defense expenditures in 1941 will be $5 billion as against the $1 8 billion proposed in the President s budget of Jan 1940 See *Fortune* Nov 1940 U S Defense Dollars

In contrast to armament expenditures is the money spent by the state for education These expenditures create an opportunity for individuals to develop such innate capacities as they possess Not only is the person receiving the education benefitted in that he may as a result of his schooling live more pleasantly and productively but society gains to the extent that it now has a more useful worker than it would otherwise have had It is difficult to conceive of a more worthwhile expenditure than that which makes it possible for one to develop to the full those qualities with which he has been endowed

Pump Priming [9]

The decade of the thirties witnessed an expansion in national governmental expenditures unprecedented in times of peace Federal appropriations in the billions of dollars became the order of the day A marked change occurred in the attitude of the federal government toward business depressions These recurring breakdowns that have characterized competitive capitalism ever since its inception were no longer viewed as being beyond the pale of proper government action Rather than await the recovery which some people believed inevitable if the natural economic forces were let alone to work their magic, the administration elected to office in 1932 determined to throw the full force of the government s weight behind positive legislation making for recovery

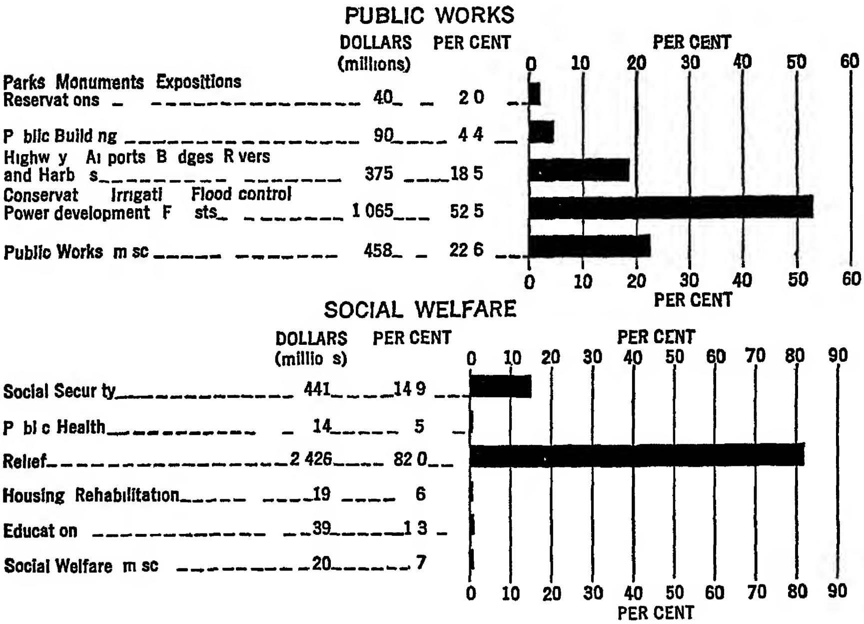
Pump priming was introduced by the Roosevelt administration The objective of this recovery measure which had been developed exhaustively in theory by Professor J M Keynes wa to activate funds that were then lying dormant If the banks withstand the initial impact of a depression either because of their strong financial position or as a result of government assistance, an expansion in excess bank reserves ordinarily takes place If the gap between the banks bulging with idle funds and business desirous but hesitant to use these funds can be bridged business activity should revive In light of the conditions extant during a depression it is unlikely that this flow of money and credit will begin of its own accord It is to the government that the proponents of pump priming turn in their quest for a solution to this problem Enjoying a credit rating superior to that of the ordinary business concern or the run of the mill municipality the federal government can enter the capital market borrow these idle funds on favorable terms and through a program of public construction put this money to work

As these expenditures are made, idle men are immediately employed This money, moving into the channels of trade gives a fillip to business constituting as it does for the most part a net addition to purchasing power The total effect of such expenditures upon business activity however is not limited to the initial outlay Subsequently a series of additional

[9] See Chart 2

expenditures results from this action causing the total volume of monetary business transactions to exceed the sum originally borrowed by the government To illustrate assume that the government borrows a million dollars to construct a public building The contractor upon completing the work receives the million He in turn, pays a large percentage of

CHART 2 [10]
EXPENDITURES OF THE UNITED STATES GOVERNMENT
(By Function Fiscal Year Ending June 30 1939)



this sum to his workers as wages they are then in a position to increase their purchases of food and clothing The merchants from whom the workers purchase these goods can expand their inventories This in turn benefits farmers and wholesalers Thus the benefits of the original outlay are spread throughout the entire economy

To many this procedure smacks of economic perpetual motion If all this be true isn t it reasonable to assume that a single dollar thrown into the economy should start the wheels turning and with gathering speed continue to whirl until everyone was busily employed? The reason that it isn't quite so simple is due to the presence of leakage Instead of the total amount spent by the government being passed on as effective demand part moves out of the stream and forms stagnant pools This occurs when for example the contractor indebted to his bank uses part of the money which he has received to liquidate this obligation If the

[10] F om D Anderson *Taxation and Recovery*

bank is already replete with funds this money finds its way into excess reserves It is potential lending power but for the time being it is nothing more than this The worker may elect to save part of his income rather than spend it and a situation similar to that of the contractor may result Possibly the value of money may fall decreasing the volume of business any given quantity of money can support

There is one aspect of this theory which too frequently is forgotten And this oversight contributes greatly to many of the misunderstandings surrounding pump priming In a competitive capitalist economy such as ours governmental expenditures of this nature are assumed to be temporary in character an expedient which is to be abandoned as soon as recovery makes its appearance As recovery starts in response to these extraordinary governmental outlays private business is to take hold with ever increasing vigor and carry the economy to a full and sustained recovery As the tempo of private production increases government spending is to taper off until it finally ceases Business men make commitments on the basis of inferences which they draw from available information They are willing to invest if in their opinion the prospects of a profitable return are sufficiently great If on the other hand they are convinced that the policies formulated by the government are injurious to business in that they are unfairly competitive or involve a repressive system of taxation, then the hoped for expansion in business does not materialize Hence ability of the highest type is requisite to create a psychological environment conducive to business activity and at the same time to conduct a spending program that involves the pumping of billions of dollars into the economy If this dual objective is not achieved pump priming as originally conceived fails

Public Works Program [11]

The governmental and quasi governmental agencies created to direct the flow of funds into the economy were many in number Among these were two which particularly attracted wide public interest the Public Works Administration and the Works Progress Administration The objective of the public works program was to increase employment quickly by restoring consumers purchasing power and the demand for capital and other durable goods

The act permitted the federal government either directly or through grants or loans to states municipalities or railroads under certain limited conditions (a) to construct repair and improve public highways parkways and public buildings, (b) to conserve and develop natural re

[11] P W A spent in 1937 $767 millions 1938 $664 millions 1939 $928 millions 1940 $1 021 millions These figures include public buildings highways rivers and harbors T V A rural electrification See Bulletin of the Treasury Department Oct 1940 Also chart 2

sources including control to utilize and purify water to prevent soil or coastal erosion to develop waterpower transmit electrical energy (c) to construct reconstruct alter or repair under public regulation or control low cost housing and slum clearance projects (d) to make loans for the financing of such railroad maintenance and equipment as may be approved by the Interstate Commerce Commission as desirable for the improvement of transportation facilities Without unnecessarily extending this list or detailing the administrative organization and procedure it should be evident that the attack was to be made on a broad front

The passage of the act and the raising of the money were but steps toward the ultimate goal of construction A public works program rests upon the assumption that only socially needed projects will be undertaken haphazard building just to give men jobs is not strictly speaking a legitimate part of such a program The administration in its endeavor to minimize waste and to protect itself against accepting projects of questionable value scrutinized each request thoroughly These efforts prolonged the period between the initiation of the request and the actual beginning of construction

There is also the technical difficulty of finding suitable public works in areas with a high incidence of unemployment Ofttimes the locality which vitally needs public construction is not the one which suffers from widespread unemployment When this situation exists an issue is raised Should the project be undertaken in the community where improvements are most needed or in those sections where unemployment is most severe? If the first of these two alternatives is chosen then it becomes necessary to import the required labor force If the second is elected the government is open to the criticism of wasting money on unnecessary construction Not only does this dilemma complicate the situation but partially explains why at times seemingly more worth while projects are passed over for others less acceptable

The task of the government is made doubly difficult because of the opposition of private business to projects which it believes competitive This opposition narrows the field of free government choice One can recall without unduly taxing his memory the bitter attacks against the T V A on the ground that it was invading the field of private business

The projects sanctioned by the P W A for the most part have required workers who possess that type of specialized skill acquired in the construction industries The number of men with this training constitutes only a small percentage of the total volume of unemployed And moreover, in any given community there may be for all practical purposes what amounts to a total absence of such skill Are the pressing needs of the unfortunates to take precedence over the insistent demands for maxi

mum efficiency? If their requirements are held to be of paramount public concern then the construction will go forward in spite of the limitations set by this lack of skill

Problems of this nature militate against a public works program achieving the desired degree of success Also these impediments contribute to the introduction of additional and supplementary activities for the relief of the unemployed The Civil Works Administration that much criticized attempt to succor needy men during the winter of 1934 owed its existence chiefly to the pedestrian pace at which the P W A moved in its earlier months As winter approached and as few projects were actually under construction, millions of men were faced with the unenviable prospect of a prolonged period of suffering To meet this emergency the C W A was instituted From its inception this agency was viewed as nothing more than a temporary expedient to be discontinued as the P W A accelerated its pace Many of the projects sponsored by the C W A were of little value in themselves frequently they were performed in a not too efficient manner But great as were these shortcomings hundreds of thousands of men were provided for who otherwise would have been in dire need And as the P W A moved forward the government, in keeping with its stated intention terminated the C W A

Many sections of the unemployed failed to benefit directly from the P W A Thousands of musicians actors writers white collar workers teachers, unskilled laborers and others because of the conditions incident to employment on public works were not provided for under the P W A It was to take care of these people that the Works Progress Administration was brought into being [12]

The W P A can be distinguished from the P W A in spite of the alphabetical similarity in that the former is an example of work relief the latter of public works Too the W P A projects were carried out directly by the government whereas the P W A projects were contracted by private construction companies under contract to the government Possibly the fact that P W A projects were done by private business while W P A projects were not may, in part account for the difference in attitude of many people toward these activities In practice the line of demarcation between the two is not as sharply defined as it is in theory Work relief is provided on the basis of the need of the recipient public works depends in theory at least on the need of the community for the construction Before an unemployed person can establish his claim for this assistance under the W P A he is subject to an investigation by a board competent to determine his eligibility After his status has been certified, he is provided with a job, more or less adapted to his capacities at such

[12] The W P A spent in 1937 $1 896 billions in 1938 $1 472 millions in 1939 $2 240 millions in 1940 $1,478 millions Bulletin of the Treasury Department Oct 1940 p 5 Also see chart 2

hours and wages as will assure him a monthly income sufficient to maintain a standard of living based upon a predetermined relief budget

The endeavor to develop opportunities suited to the capacities of those seeking relief gave rise to the theater projects the fine arts projects the writers projects the sewing projects the research projects the construction projects and many others too numerous to list To a nation which traditionally viewed unemployment as an individual responsibility to be met by an ill assorted array of makeshifts inadequate to the occasion this acceptance of the tragedy as a social responsibility evoked conflicting reactions In many discussions impassioned partisanship played a more prominent role than considered judgment There was a tendency on the part of some to damn these efforts as boon doggling others refused to see any imperfections in the program To many the government was pampering an indulged group which would find work if this disgusting waste were only terminated To others the government was exhibiting a high degree of intelligence as well as a high purpose in preserving our cultural heritage by these expenditures

Work Relief and Relief Work

Work relief unquestionably is more costly to the government than a system of doles if the accounts are recorded exclusively in monetary terms A system of doles does not necessitate as heavy outlays for materials or equipment as does a works program And too the dole would be markedly less than the average wage paid on the works projects However there is an additional cost that must be included in the accounting if the records are to be kept accurately There is a social cost involved in a dole system which cannot be lightly dismissed even though it is not quite so obvious as is the financial cost A dole system in supporting the unemployed in idleness will ultimately turn these unemployed into unemployables This inescapable idleness sets in motion a process of deterioration which in the end destroys the productive capacity of this labor power Thus a resource of the greatest value man power, is wasted by a mistaken concept of economy

Skill comes to a man as a result of diligent application at some given task over an extended period of time The skill thus acquired remains his only on the condition that he continues to use it Prolonged idleness robs him of this attribute but does it subtly There is no sudden and abrupt shedding of this skill but a slow often unconscious giving up which is not fully realized until the worker, once again turning to his accustomed task finds his artistry gone The only insurance protecting the worker against this loss is constant employment

A works program seeks to protect the worker against this calamity Rather than support him in idleness the program creates an opportunity for him to use his skill and by that very act to preserve it When the

emergency has passed he then can return to prıvate employment as he left —a skılled productıve worker

Thıs reasonıng however must not be over worked nor should sweep ıng generalızatıons be elevated to the dıgnıty of sacrosanct dıcta The skılled workers constıtute but a small percentage of the total volume of unemployed There are thousands who have no skıll to preserve for them ıt ıs only a matter of preservıng human dıgnıty[18] Though thıs percentage of skılled workers ıs small ıt covers too large an absolute number of men and women for socıety to grow careless about theır future

On the credıt sıde of the ledger should appear the contrıbutıons made by the W P A to the comfort the enjoyment and the socıal wealth of the natıon What otherwıse would have been enforced ıdleness was turned ınto 17 000 new publıc buıldıngs 15 000 playgrounds 29 000 brıdges, 279 000 mıles of hıghways and many other gaıns Even the water closets that afforded polıtıcal commentators and cartoonısts such an ex cellent opportunıty to dısplay theır wıt brought to many people for the first tıme contact wıth the most elementary requırements of sanıtatıon Above all these men and women had opportunıtıes to earn theır lıvelı hood and through thıs work not only contrıbuted to the natıonal welfare, but, just as ımportant preserved theır personal dıgnıty

Many mıstakes were made as ıs always true when great plans are ın the makıng But the ınexcusable blunder would be commıtted ıf these errors were perpetuated because of some warped loyalty to the program Progress can be made only when these mıstakes expedıte correctıve legıslatıon Thus only can the program be protected agaınst the erosıon of waste polıtıcal corruptıon and human deterıoratıon

Conclusıon

The object of all governmental expendıtures should be to make men more able and wıllıng to work and to guıde materıal resources ınto theır most productıve employment If these ends are achıeved, then the gov ernment wıll be makıng ıts contrıbutıon to the Amerıca of whıch men have long dreamed—a natıon from whıch ıgnorance and dıre poverty have been banıshed

[18] Preservatıon of dıgnıty suffered from the stıgma whıch the opponents of relıef at tached to W P A work Thıs attıtude ıs part of that general pattern of thought that tends to ıdentıfy all non prıvate busıness actıvıtıes as unproductıve

CHAPTER 22

TAXATION

The principal instrument upon which modern governments rely for the major portion of their revenue is taxation[1] In the fiscal year 1937 38 approximately $13 000 000 000—1/5 of the national income—were collected by the various governments federal state and local in the United States Of this total $6 000 000 000 went to the federal government $2 750 000 000 to the state governments and $4 500 000 000 to the local governments Had these taxes been apportioned on a per capita basis each man woman and child would have contributed $100 Since most American families, according to a recent study of the National Resources Committee receive less than $1200 per year they pay considerably less than this average amount Just as on the other hand the very well to do pay markedly more

In addition to taxes there are other instruments used by governments to raise revenue Licenses fees special assessments and prices also contribute to the treasuries of the various units of government If however the amount of revenue raised is accepted as the criterion of fiscal importance all of these combined must accept a position of minor importance in the fiscal structure Taxes supplying as they do over 90% of the government s income are of such paramount importance that attention will be focused upon them primarily

Characteristics of a Tax

A tax may be used either for the raising of revenue or for the regulation of certain socio economic activities This separation of functions is not so clear cut as the foregoing statement may permit one to infer It is rare indeed for a tax introduced for revenue purposes to be economically neutral It necessarily causes those affected to modify their actions if but slightly And too it is just as probable that a regulatory tax will yield some revenue If the attempt be made to establish this distinction by seeking out the intent of Congress numerous problems of a most vexing type will be encountered What Congress intended any given tax to accomplish involves one in a maze of congressional debate marked more by tortuous reasoning than by illuminating discussion Even if it were assumed that the intent of Congress sould be established an assumption

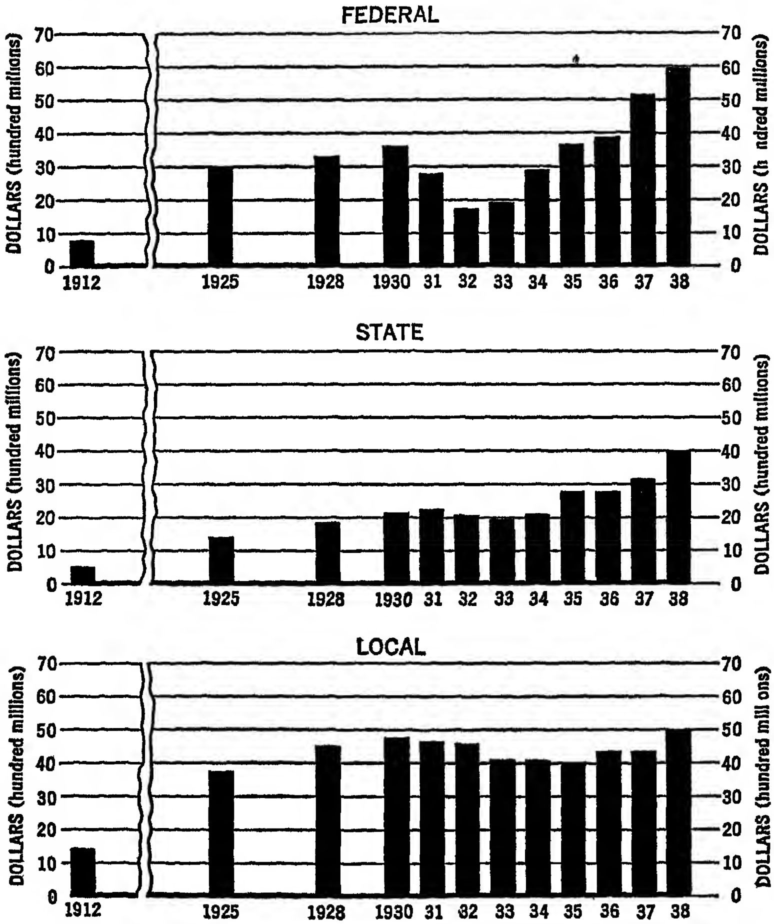
[1] See Charts 3 and 4

that few would accede to the courts in interpreting the law may through their decisions modify if not basically change the original purpose of the legislation Yet in spite of these limitations and they cannot lightly be brushed aside a tax for revenue purposes will be defined as a compulsory

CHART 3[2]

TAX COLLECTIONS IN THE UNITED STATES

(Selected Fiscal Years by Level of Government 1912 1938)



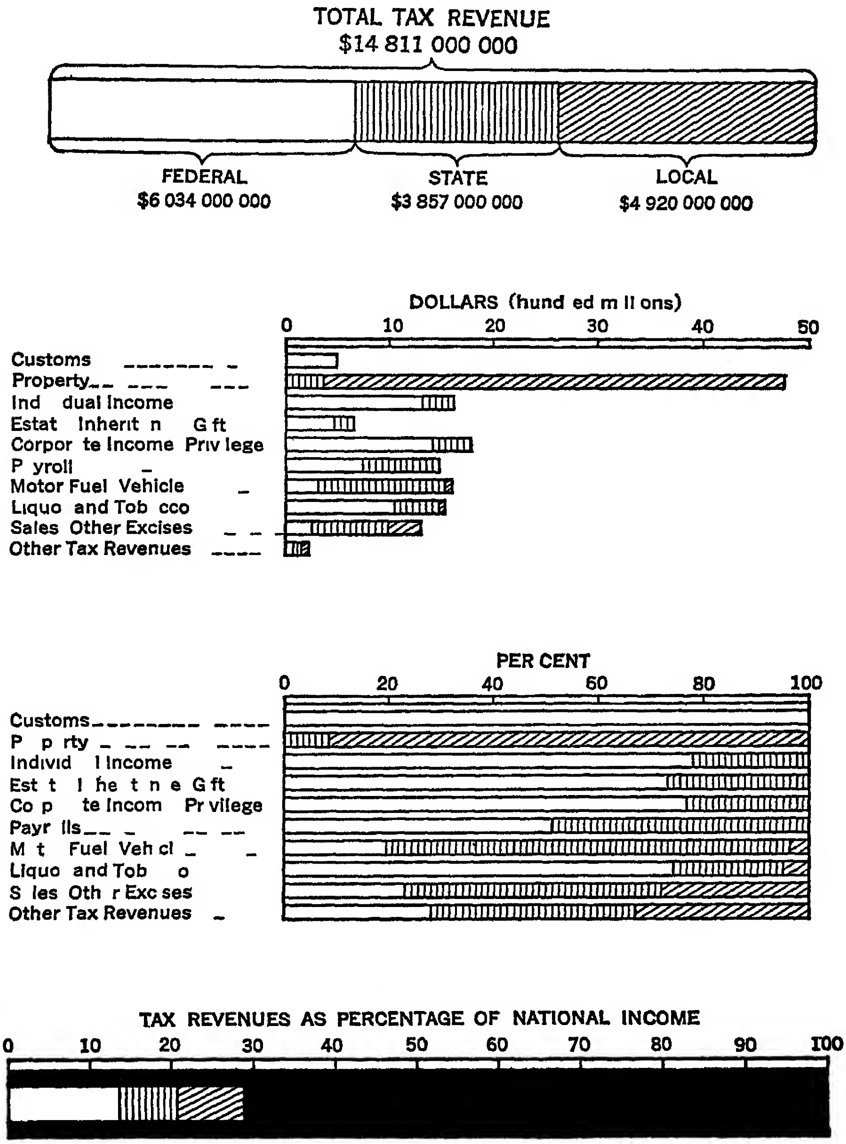
contribution made to the government by persons and businesses to defray the costs of those state functions which do not involve a quid pro quo while a tax for purposes of social control will be understood to be an instrument used by the government to influence economic activity in certain specific ways regardless of the revenue which may incidentally be produced

D Anderson *Taxation and Recovery*

CHART 4 [3]

TAX REVENUE SYSTEM OF THE UNITED STATES

(Type of Tax by Level of Government Fiscal Year 1938)



[3] D Anderson *Taxation and Recovery*

The first characteristic which sets a tax apart from other forms of payment is the presence of compulsion The individual or business falling within the conditions prescribed by the state for tax liability has no effective choice in the matter other than to pay That this act is coercive is not in dispute but before one leaps to the attack on the grounds that coercion is incompatible with democracy let it be remembered that the coercion to which reference is here made is the legalized coercion of a democratic state operating under a constitution

There are some who deny that compulsion is a uniquely distinctive characteristic of a tax They point to commercial prices insisting that here too is to be found coercion That there is an element of compulsion in some commercial prices cannot be denied but the coercion in the sphere of commerce is in direct relationship to the degree to which the purchaser depends upon that particular good for the satisfaction of his wants And his dependence upon any particular good is determined by the availability of acceptable substitutes Hence the distinction between certain prices especially of monopolistically produced goods, and taxes is one of degree rather than of kind But generally speaking the difference in degree is sufficiently great as to permit assuming a difference in kind

The second characteristic of a tax is the absence of a quid pro quo—a this for that When a commercial purchase is made the buyer exchanges his money for some specific good of his own choosing In the case of a tax on the contrary this direct relationship between payment and receipt is absent The concept which held that there existed a contract between the individual and the state under which the citizen paid taxes in return for specific benefits has given way before the advance of the philosophy of social solidarity Today, with certain notable exceptions a tax is considered to be a payment in support of those general immaterial functions such as protection or education in which the taxpayer may or may not share directly and if he does, his participation may bear little if any relationship to his tax contribution In short the bestowal of a specific benefit is no longer accepted as a necessary prerequisite of tax liability Membership in a group adhering to a certain behavior pattern suffices to establish his liability

The Criteria of a Sound Fiscal System

In providing the large revenues required by modern governments, it is imperative that the task be done in the most efficient and equitable manner possible. Injustices which are borne uncomplainingly when the tax burden weighs lightly will evoke bitter complaint when the pack is overloaded Inefficiencies which go unnoticed when revenues are meager in amount may jeopardize a fiscal structure when receipts reach larger proportions Unless some reasonable and objective criteria for evaluating a tax system can be agreed upon judgments as to its soundness must re

main largely the expression of personal whims prejudices or traditional attitudes

Students, fiscal administrators and experienced men of affairs have pooled their knowledge so that a set of rules could be developed which would assist those who seek in the fiscal sphere some things more substantial upon which to base an opinion than an indiscriminating imagination The rules which have resulted from this expenditure of time and effort are the canons of taxation

In applying the canons of taxation ample latitude must be permitted for acknowledged differences of interests and points of view Public officials combing the economy for funds will be more attentive to the administrative canons such for example as that of adequacy than would be the ordinary taxpayer interested as he naturally is in his own immediate tax problem The average citizen will be most interested in the canons of equity and economy and this interest usually expresses itself by his demonstrating always to his complete satisfaction that his tax burden is exceedingly oppressive and if justice is to obtain should be shifted to someone else A fiscal policy if it is to be successful must first recognize and then harmonize the legitimate claims of these divergent interests Moreover, such a policy must take cognizance of the dynamic character of modern society and in recognition of this fact must contain that degree of flexibility which will permit of adaptation to changing social conditions A good tax system therefore must be a system in fact as well as in name—it should constitute a unified balanced and harmonious whole and above all it must avoid being merely a collection of inarticulated disjointed parts loosely held together by the hand of political opportunism or outmoded tradition

The Criterion of Adequacy

The first rule of sound fiscal policy is that the tax system shall raise revenues adequate to meet all the ordinary obligations involved in performing the customary services of government This is the rule of adequacy the first of the canons of taxation The welfare of the community demands that essential public services shall be neither discontinued nor impaired because an antiquated or improperly constructed tax system is unresponsive to the fiscal needs of the state Nor shall collective acquisitiveness so blind legislators that they lose sight of the fact that tax rates can be pushed to a point where returns diminish and industry stagnates Whatever other purposes of a non fiscal character taxation may properly have and they are many and of increasing importance its fundamental purpose is to provide revenues in quantities sufficient to guarantee the continued and efficient performance of all necessary government functions

Consequently if depleted coffers are to be avoided as contrary to ac

cepted fiscal practice it is necessary that the aggregate yield of the tax structure shall respond and promptly to the changing fiscal requirements of the state Future exigencies may best be anticipated by including in the system one or more taxes whose yield will respond to variations in the tax rate If this should be done the treasury has insured itself against that type of budgetary embarrassment which a tax structure of unnecessary inflexibility occasions

Steadiness of tax yield depends in part on the relationship which sensitive taxes bear to non sensitive taxes in the system as a whole Sensitive taxes are those whose yield reacts markedly to fluctuations in business activity non sensitive taxes are those whose yield is more resistant to changes in general business conditions The federal income tax —which is incidentally a combination of two taxes the personal income tax and the corporation income tax—excellently illustrates the former type During the decade of the twenties this tax was the principal source of federal revenue supplying between 55% and 60% of total receipts In absolute figures this tax returned $1 762 000 000 in 1925 and $2 411 000 000 in 1930 This high level of yield was maintained during this period even though the rates were reduced on several occasions The treasury surpluses which were experienced during these ten years are explained by the responsiveness of this tax to this period of unexcelled prosperity

By 1934 the sensitivity of the income tax had been convincingly demonstrated In the third year of the depression the yield of the tax was almost $1 700 000 000 less than in 1930 a decrease of 69% and this despite the increases which had been made in the rates This shrinkage alone accounted for almost the entire decline—50%—which occurred in the federal tax yield between 1930 and 1933 That a decrease of such magnitude is possible in any single tax emphasizes the need of compensating for these sensitive taxes by including in the tax structure other, less sensitive taxes

The fact that the personal income tax rates are progressive reaching a maximum of 79% on the increment of income in excess of $5 000 000 explains why income tax receipts increase more than proportionately with an increase in national income [4] It is also this progression which causes a fall in the national income to occasion a more than proportionate decrease in income tax returns In consequence of this rate policy plus the other provisions already alluded to the income tax exhibits high productivity in periods of expanding income, whereas in periods of depression its yield will be greatly reduced

In contrast to the fluctuations in yield which characterize the income

[4] It should be noted that another factor contributing to the sensitivity of this tax is the narrowness of its base The law until the 1940 changes exempted the bulk of citizens Out of a population of 132 000 000 only some 3 to 4 000 000 file income tax returns and of this number only 1 500 000 approximately pay a tax

tax, is the stability of return exhibited by some of the excise taxes Excise taxes or, if it be preferred internal revenue taxes are levied upon the right to manufacture or sell certain selected commodities destined for domestic consumption The tax upon small cigarettes is an example of this type of tax If the excise be placed upon goods of inelastic demand the yield will not be so responsive to industrial fluctuations The returns from the cigarette tax have increased steadily during the last two decades with the exception of two years 1931 and 1932 In 1931 this upward trend was interrupted when the yield fell from the $360 000 000 reached in 1930 to $359 000 000 In 1932 the return was $317 000 000 the least yielded by the tax during the depression Since 1932 the yield of the tax has constantly grown reaching $425 000 000 in 1937 It is this greater resistance to cyclical fluctuations in business that has turned many governments when hard pressed for funds to taxes which fall upon goods of inelastic demand

In summary to insure adequacy in these times of expanding expenditures the tax system must be composed of several groups of taxes for to rely exclusively or even too extensively upon any single tax is to court fiscal disaster A system so constituted will be more capable of withstanding the impact of a depression than one resting too heavily upon a few highly sensitive taxes The sensitivity of the United States income tax does not argue for the relinquishment of income taxation itself In fact the inclusion of the income tax is a first prerequisite of any modern system of taxation The significance of the foregoing presentation was to emphasize that the tax as used in the United States with its narrow base its treatment of capital gains and losses its rates of progression is very responsive to fluctuations in business conditions Owing to political constitutional and administrative obstacles it is improbable that all of these weaknesses will be corrected The most practical way therefore to compensate for the sensitivity of the income tax is by including in the structure certain carefully selected excise taxes which have demonstrated their greater resistance to changing business conditions

The Criterion of Economy

The second rule of sound fiscal policy is that the tax system shall not be repressive to industry This is the rule of economy the second of the canons of taxation Any system of taxation will affect the economy in some way but the restrictions to be avoided are those which *unduly* repress industrial activity[5] Modern governments require sums of such magnitude to finance their expanding activities that a tax program which deters business from accepting its customary responsibilities will in the end prove self destructive If the tax collector should dip too deeply into the pockets of business men they will hesitate to make capital commit

[5] See *Fortune* Dec 1940 particularly pp 168 169

ments A slackening off in industrial activity will ensue with a concomitant decline in the national income Thus the very source from which the government secures its revenue will tend to dry up Important as is this aspect of the problem there is another of even greater significance—the welfare of the nation A high standard of living which after all is the ultimate objective of all economic endeavor is as dependent upon an efficient and continuous utilization of the country s productive facilities as is the revenue system Hence a tax program which owing to basic defects obstructs justifiable business investments is especially vicious for not only does it destroy itself but in committing that act pulls down with it the rest of the economy

The particular point at which the rate of taxation becomes *unduly* repressive cannot be stated with mathematical precision The decision to invest is a man made decision and as such depends less upon the specific rate in force than upon the investor s reaction to that rate If the investor rightly or wrongly convinces himself that the net return after taxes is insufficient he will not hazard his funds The specific rate which will cause men to hesitate will differ with different men and with the same man relative to different investments Fundamentally, it is a matter of the psychological reactions of those with free investment funds The only practicable test available to the tax administrator is the pragmatic one of pushing up rates and studying reactions

Before investigating the specific manner in which certain provisions of the tax laws affect industrial activity, an additional consideration should be noted Investors before committing themselves to any given course of action endeavor to determine within the limits set by their own capacities and the availability of pertinent information the return which can reasonably be expected if success is to attend their venture Such calculations involve anticipating the future trend of events Prediction rests upon the assumption that things to come will unfold in accordance with some foreseeable pattern rather than in obedience to the whims of some fickle god of chance Yet it is not perfect knowledge which business expects but an assurance that the sequence of coming events will exhibit sufficient regularity in their development as to permit the use of the law of probabilities If, however, the government should subject the tax structure to frequent and unexpected changes predictions will become less and less reliable Business unable any longer to project its thinking into the future must either haltingly grope its way forward or crawl into its hole and await the return of an administration whose tax policy gives promise of a more propitious time

The problem immediately at hand—the effects of specific taxes upon business activity—requires an analysis of the particular manner in which certain taxes influence investments The inquiry can best be posed by stating the issue in the form of a question Is there evidence to substantiate

the contention that some taxes now in force interfere with investments particularly those of a venturesome type?

Although the tax upon personal incomes is customarily thought of as a single tax it is in fact a composite of two taxes, a normal tax and a series of surtaxes The normal tax levied at a flat rate of 4% applies to all taxable income after certain permissible credits and deductions have been excluded In addition to this tax there is a series of surtaxes which fall upon those taxable incomes which exceed $4 000 To compute surtax liability taxable income must be broken into a series of increments so that the appropriate surtax rate for each bracket can be applied These rates which begin at 4% on the increment of taxable income between $4 000 and $6,000 increase until the maximum rate of 75% is reached on the increment above $5 000 000 Thus when the normal tax is combined with the surtaxes the personal income tax rates progress from a minimum of 4% to a maximum of 79%

The rates on taxable incomes of $50 000 or less are not unreasonably high [6] Throughout this entire range the burden imposed by the personal income tax in the United States is light compared to that imposed by the income tax in Great Britain However, when the $50 000 bracket is passed the rates increase at a pace which to many is breathtaking On the increment of income in excess of $100 000 the rate is 62% on that exceeding $500 000 74% and on that above $5 000 000 the rate reaches its maximum of 79% Thus while in the lower ranges the American fares better than the Englishman this does not hold true in the upper brackets

The percentage of one s income taken by the government is increased owing to the number of states which now make use of income taxes When these combined federal and state contributions are computed as a percentage of an individual s annual income, the resulting figure causes many people to fear the effects that this policy may have upon the character and volume of private investments

In a capitalistic competitive society economic progress is inextricably

[6] U S Federal Income Tax 1940*

Income	*Tax*	*Rate*
$2 500	$11 00	0 44%
3 000	30 80	1 03
4 000	70 40	1 76
5 000	110 00	2 20
10 000	528 00	5 28
20 000	2 336 40	11 68
50 000	14 128.40	28 26
100 000	43 476 40	43 48
500 000	330 155 60	66 03
1 000 000	717 583 60	71 76
5 000 000	3 916 547 60	78 33

* Total tax and percentage of net income payable by a married person no dependents all income earred *Fortune* Nov 1940 p 79

associated with the willingness of those with free funds to risk their money in venturesome undertakings The door to new industries is opened only to those who dare Yet one would be little less than foolhardy if he were to charge through knowing full well that even though he escaped the pitfalls hidden on the other side his good fortune would at best be of slight avail So too it is with the investor He hesitates to hazard his funds if convinced that the most he could expect would be a net return of meager size

An example may better illustrate this situation[7] Assume that one has an investment opportunity which offers equal chances of success or failure If good fortune accompanies the endeavor the investor stands to make $100 000 on the contrary if the undertaking should fail he would lose his original investment of say $50 000 Faced with such a choice he may venture his money feeling that the possible gain justifies his assuming the risk Actually however he is keenly aware that the alternatives as stated do not accurately depict the situation There is another participant a silent partner who will share his success with him—the government The size of his net return assuming him to be successful will depend upon the personal income tax which he will have to pay And the amount of the tax will in turn be determined by the bracket in which his income happens to fall Since most personal investments are made by those fortunate enough to enjoy sizeable incomes the rates which such incomes bear are among the highest When this factor is accounted for the investor will find that his net return is no longer $100 000 but only a fraction of that sum His evaluation of the situation will be markedly affected by this tax He may abandon the project completely justifying his action on the basis that the net return does not warrant his assuming the risk Thus is it possible for a tax to reduce the total volume of investments

Not only may the amount of investments decrease but their nature may be affected by an ill advised set of rates Investments of a venturesome type may be shunned and safety sought in the purchase of low return seasoned securities Or to avoid what is believed to be unjustifiably high rates tax exempt bonds may be purchased If either of these results obtains, the flow of funds is diverted from the riskier forms of enterprise into businesses of a less speculative character And, although a less sanguine attitude toward future earnings is the policy of wisdom in a period of expanding prosperity the encouragement of investments particularly of a frontier breaking type should be the objective of tax policy during a period of business stagnation A seeming contradiction can thus arise

[7] It should be remembered that although the income tax and investments are herein used to illustrate the canon maladjustments can also result from too heavy taxation of consumers expenditures At a time when increased consumers expenditures are desired heavy taxation can so decrease these expenditures as to defeat the end desired Too the property tax has reached so high a level in some communities that some hold that it is a deterrent to building

as a result of misguided tax legislation—an abundance of funds seeking investment outlets and simultaneously a lack of funds available for investments of a particular type

Although justice requires that the personal income tax be adjusted so as to secure from the wealthy a contribution which accords with their greater ability to pay it does not condone rates which are repressive to industry The opportunity for employing capital and men in quantities of sufficient magnitude to be economically decisive depends upon the discovery of new enterprises and the expansion of those already in existence

The Criterion of Certainty

The third rule of sound fiscal policy is that the tax law shall be phrased with sufficient clarity so that there will be no doubt as to its meaning and that the taxes shall be administered efficiently and fairly This is the rule of certainty, the third of the canons of taxation If the tax laws are obscured by faulty phraseology if even the experts find themselves at odds over the interpretation of some section of the law confusion is inevitable Prolonged litigation expensive and annoying both to the government and the taxpayer results Until these uncertain passages are clarified the rights of the individual and the government are indeterminate Such a situation is not conducive to a more amicable relationship between the citizen and his government Sore spots which may already exist in the body politic are aggravated If in addition the tax system is administered inefficiently the costs of collection become unnecessarily great and in spite of these enhanced expenses, the tax system is brought into no closer accord with its original purpose

Customarily the efficiency with which a tax system is administered is determined by ascertaining the percentage of the revenues raised that is absorbed in the collection process This technique seems simple enough but its very simplicity is deceptive Although tax collections can be computed without undue difficulty it is well nigh impossible to obtain accurate cost figures There is an overhead cost of administering the tax system and to allocate to each separate tax its share of this overhead can at best be nothing more than a questionable approximation The accuracy of such cost figures as are obtained depends too upon the sincerity with which the law has been enforced If a serious attempt is made to collect from everyone liable to the tax the cost of administration will be considerably higher than if the difficult cases should be avoided Most taxpayers willingly cooperate with the government and little or no coercion is needed to secure their compliance with the law However there is a fringe which pays with the greatest reluctance Those who compose this group may be viewed as the marginal payers The cost which their unwillingness entails might equal or even exceed the total amount of taxes collected from them Thus in computing the cost of administration some

information should be had concerning the effort exercised by the government in reaching these hard cases

There are other costs which are not usually included when cost calculations are being made The government uses the courts to enforce the tax laws judges must preside in order that decisions can be rendered Yet these costs of the judiciary are not considered to be part of the general cost of administering a tax system Furthermore it is not uncommon for the government to rely upon private business to act as a collecting agency Costs may be minimized by having the tax paid by the wholesaler and then have the wholesaler, by incorporating the tax in the price he charges pass it on to the consumer This technique reduces administrative costs by restricting such investigations as must be made by the government to a limited number of relatively large business units having efficient accounting systems This method of indirect collection from the ultimate consumer entails additional clerical work on the part of the wholesaler thus increasing his costs It has been computed that the performance of this function necessitates an additional outlay of as much as 12% of the taxes collected by these companies[8] It should be noted that the costs borne by the business in acting as a collecting agent for the government do not appear in the government s cost of collection figures

A better understanding of this rule can be had by applying the rule to the sales tax The phrase sales tax is a general and somewhat vague term under which is subsumed a number of taxes levied upon various types of sales For the problem immediately at hand, a concession will be made to accuracy, and the term sales tax will be used synonymously with *retail* sales tax a tax now in use in approximately half of the states of the union and finding favor in a growing number of municipalities While in adapting the retail sales tax to the particular characteristics of any given state it is subject to modifications, nevertheless in general it operates as follows It is a tax levied on commodities at retail sale as its name indicates, excepting the sale of labor services and at times the basic necessities of life Ordinarily the rates vary between 2% and 3% of the retail price of the goods

This tax was resorted to either as a temporary expedient to meet a fiscal emergency engendered by the depression or as a substitute for the property tax as a source of state revenue It proved so productive however that its temporary character was conveniently forgotten The high favor in which many administrators hold the tax an affection which frequently blinds them to its many imperfections can be explained by the $400 000 000 per year—6% of the total of state and local revenues—it yields A sum of this magnitude especially during a period of depressed business is not likely to be discarded readily

[8] Twentieth Century Fund *Facing the Tax Problem* (N Y 1937) pp 341 345

In most communities the bulk of retail business is done by a limited number of individual stores Since these units are few in number and have efficient accounting systems they can be checked by the tax officials thoroughly and often without causing the costs of administration to exceed ½ of 1% The major administrative problem arises when a decision must be reached as to the treatment to be accorded that multitude of small retail shops whose annual volume of business is meager and whose system of accounts is rarely more than a haphazard jotting of notes on the back of discarded envelopes If these businesses are frequently inspected at regular intervals the administrative costs in so far as they specifically are concerned are apt to equal if not exceed the taxes collected from them If owing to these prohibitive costs no real effort is made to enforce the law in so far as it applies to them the tax ceases to operate as it was intended

The states confronted with this administrative dilemma have attempted to extricate themselves from the horns in a variety of ways In some states no endeavor is made to reach retailers directly The expedient which is resorted to is that of collecting the tax from the wholesalers and having them in turn collect from the retailers through the medium of a sales transaction The advantage to the state in following this technique is that collections are centralized and administrative costs are minimized However the economy which the state enjoys has been made possible by turning the wholesaler into a governmental collecting agency If the administrative costs were to be accurately computed there should appear in the final reckoning the increased expenses which this task—tax collecting—has caused the business

Another method used to minimize administrative costs is that of sampling The government aware of the prohibitive costs incident to any system that necessitates a minute inspection of every retail outlet selects at random some given number of the smaller stores for investigation Since the retailers cannot tell beforehand which of them will be inspected pressure is brought to bear upon them all to respect the law

The difficulties which inevitably arise when the rule of certainty is flaunted are well illustrated by the property tax This tax which is the greatest single revenue producer in the country yielding some 4 500 000 000 in 1939 is the mainstay of local governments Over 90% of the total taxes collected by local governments is derived from this one source and even though in some state systems other taxes are tending to replace the property tax it continues to be a primary source of revenue in most states

The *General Property Tax* is a proportional tax levied upon all property other than those items which the law specifically exempts The property in each district is listed and valued by a group of locally elected or appointed assessors The law states that the assessors shall fix a value upon the property equal to the sum which it would command at a fair sale The total of these individual items constitutes the assessed value of

property or as it is sometimes called the Grand List After the community has determined the amount of taxes which must be raised the tax rate is computed by dividing the taxes into the assessed value of the property This rate is then applied to the assessed value of the property owned by each individual in order that his personal property tax liability can be ascertained

With the passage of time the General Property Tax has been subject to many modifications with the result that today it has become in some states New York for example primarily a tax upon real estate while in other states as for example New Hampshire it continues a tax upon almost all forms of property Thus it is important that those states or local governments which make use of a property tax be certain that the tax law is phrased with sufficient clarity so that there will be no confusion as to the types of property which are to be taxable

The major weakness in the operation of the property tax is administrative in nature And the principal administrative defect has been and continues to be incident to the assessment procedure As the nation became more industrialized the simpler forms of ownership that characterized the early nineteenth century in America gave way before the advance of a more complicated system of property and property rights This change in the concept of property made it necessary that anyone whose task it became to assess property be competently trained and carefully selected Yet it continues to be true that those selected for this important task rarely are chosen because of any special capacity for the work which they are called upon to perform Usually they are elected officers and the elements which go to make their candidacy successful bear slight if any relationship to the duties which they are called upon to perform Hence if the administration of this tax is to be improved the first corrective should be to seek out a better method of selecting the personnel of the assessing staffs A greater degree of state control over local assessment procedure would be a first step in the proper direction Too standards for testing the ability of anyone aspiring for the position of an assessor should be set up —standards which would insist upon adequate training and demonstrated ability

Correctives if they are to be comprehensive in scope, must proceed beyond the problem of personnel The unit of assessment is customarily restricted to a township or at most a county Many commercial and industrial undertakings particularly if they be of large size are not coextensive with any one local assessing district A railroad for example will pass through numerous assessing jurisdictions It is too much to expect of any local assessors, handicapped in the first instance by their lack of knowledge that they be able to determine the value of that part of the railroad system which falls within their single area It is a difficult enough task to ascertain the value of the entire system under the most

favorable auspices The only way in which the value of such properties can even be approximated is by treating the system as a unit not by breaking it into a multitude of disconnected meaningless parts This problem can be solved by either increasing the size of the assessing unit or by segregating these specialized types of property for particularized treatment

In those states where intangible property—stocks bonds and mort gages—continue to be included in the list of taxable property the diffi culties of administering the property tax are increased Owing to the ease with which intangibles can be secreted in safety deposit boxes this form of property eludes the assessors To the extent that the owners of intangibles evade the tax other owners of property are compelled to pay more in taxes On the other hand if an individual feels a deep sense of civic responsibility and declares his holdings or if ferret like assessors chase these intangibles from their holes the property tax rate when ap plied to the market value of these securities is apt in practice to be a tax of 100% or more of the income which they yield In short as long as intangibles are held to be similar to all other forms of property and rendered the same treatment as say real estate the law tends to operate uncertainly

The Criterion of Equity

The fourth rule of sound fiscal policy is that the tax burden shall be distributed in a fair and just manner This is the rule of equity the fourth of the canons of taxation One student of taxation Hugh Dalton keenly aware of the quixotic character of much that is said and written about justice in taxation summed up the convenient vagueness of many of the theories of equity in the following statement All principles of equity in taxation including the austere principle that everyone ought to pay some thing are only matters of opinion Failing a clearer and more generally accepted definition of equity than has heretofore been forthcoming it cannot be proved that they are in fact equitable but only that certain people at certain times think them so And it is a fact of common observa tion that opinions on such questions are very liable to change Equity of en seems to say No but hardly ever Yes an elusive mistress whom perhaps it is only the worth of philosophers to pursue ardently and of politicians to watch warily [9] It might also be added that justice has too often been conceived of as merely a rationalization or justification of change in a tax system which appeared to have been made necessary by changes in fiscal conditions or economic policies or by shifts in political power

Yet in spite of these acknowledged facts justice must be more mean ingful than a mere desire to shift all taxes to someone other than one

[9] Hugh Dalton *Princ ples of Public Finance* (G Rutledge and Sons London 1936) pp 79 80

self That the problem is challenging is not to be gainsaid but if the ideal system of taxation is to be approached if sign posts are to be erected pointing to sought for destinations the difficulties must be faced and dealt with as ably as possible

If the burden of taxation is to be apportioned equitably, information must be had concerning the taxes paid by individuals representative of various income groups It is on the basis of this type of knowledge that comparisons can be made and relative burdens can be determined The amount of taxes paid by an individual is not alone a function of his income important as this is Other factors must be considered such as his legal residence the size of his family the source of his income and the distribution of his expenditures Nor is the mere adding up of the taxes which he consciously pays a sufficiently accurate measurement of his tax burden to be scientifically acceptable He may unknowingly be paying many taxes which hide their identity by parading in the guise of higher prices

To understand distributive justice, those intricate and at times, exceedingly confusing problems associated with the shifting and incidence of taxation must be investigated, if but briefly It does not suffice to know only who pays the taxes in the first instance, the ultimate bearer of these taxes must be known as well This can be illustrated by the tax on cigarettes Although the manufacturer of cigarettes pays the tax to the federal government he subsequently recovers this outlay by transferring the tax to the ultimate consumer The tax constitutes a cost to the manufacturer and in order that this cost can be covered he incorporates the tax in the price at which he sells his goods This process of transferring a tax through the medium of a sale is known technically as the shifting of a tax The person upon whom the tax finally rests is termed the incidence of the tax It is through this process of shifting that many taxes are borne by consumers often without their being fully conscious of the fact

The Twentieth Century Fund in its *Studies in Current Tax Problems* presents a series of case studies which portray the tax experience of families typical of various income groups A married factory worker with two children who lives in upper New York State and earns $1 000 per annum pays in taxes some $190 a year—19% of his income Of this amount, roughly $65 are paid in the form of indirect taxes If he should be renting rather than owning his home, the $116 he now pays as a direct tax upon his property would be paid as an indirect tax included in his rent An executive similarly domiciled with a family of the same size who earns $5 000 a year, would contribute to the government approximately 21% of his income as taxes Unlike the skilled worker direct taxes play a more important role in his tax outlay A family with a taxable income of $100 000 a year also living in New York State would pay about 51% of its income in taxes

From this study certain observations can be made The cases presented indicate that very few if any families escape taxes completely Low income groups make their contributions principally in the form of higher prices As the size of the income expands especially after the $50 000 bracket has been passed direct taxes increase in importance This does not mean that indirect taxes are no longer of significance to the receivers of large incomes but rather, that indirect taxes tend to be dwarfed by the mounting direct taxes which they are called upon to pay

As knowledge concerning the taxes paid by individuals increases as taxation statistics grow more abundant and exact one will be able to speak with greater confidence of tax burdens Yet, if fact finding bodies should succeed in the gargantuan task of determining the exact tax burden borne by every single individual there would still remain a challenging question a question that would tickle the imagination and encourage the expression of opinions The issue which would still remain would be Are the taxes being apportioned in a manner that harmonizes with what people believe to be just?

As has already been stated opinions constitute a major ingredient in all theories of equity And just as opinions are apt to be as numerous as are the people who hold them concepts of justice tend to roam over a wide area If tenuous distinctions be foregone certain more obvious lines of demarcation can be established separating the more recognizable theories from each other The theories to be treated in this survey fall under two headings the *benefit theory* and the *ability theory*

The *benefit theory* holds that taxes should be apportioned on the basis of the benefits received by the users of governmental services If this is to be the guiding principle the first problem which arises is to develop some acceptable technique for measuring benefits One group of proponents of this theory advocates measuring benefits by the satisfactions experienced by the recipients of governmental services Analyzing psychic phenomena may prove a most fetching intellectual exercise but the value of this method is subject to severe limitations and for the following reasons First it is improbable that a technique could be developed for measuring these individual psychic reactions which would yield results of practical value And in the absence of a concrete measuring rod there is little else upon which an administrator could rely in the apportionment of the taxes Second even if these limitations were dismissed, the theory in operation would be reduced to an absurdity What of the destitute aged who are financially assisted because of their indigence? Since they are the beneficiaries of this consideration is it proposed that they in their penury should defray the costs of an old age assistance program? If the benefit principle is to be useful it must rest upon something more measurable than personal satisfactions

Others sensing the futility of struggling with psychic satisfactions

offer another interpretation of the benefit theory—the cost approach They would have those who use governmental services pay a tax which would cover the per unit cost of rendering the service This theory would be limited in its application to those functions for which a per unit cost could be computed While those general immaterial services such as protection and education which cannot be broken into separable units would not fit into this scheme of apportionment, the theory could be applied to the commercial activities carried on by government

In those cases where the government operates a commercial venture such as a municipally owned power plant the costs of the project are defrayed by charging a price for the service The price used however, may not necessarily be sufficient to insure against a deficit And though this may seem to contradict the basic premise upon which the cost theory rests the government may have elected to follow a rate policy which offers the service below costs This practice may have been instituted in the belief that a consumer s subsidy in the form of low cost electricity was in the best interest of society Or under an altered set of circumstances the government, desirous of profiting from the undertaking, may inaugurate a scale of prices that will yield this wanted result Thus while in theory the cost principle rests upon the assumption that the government will reimburse itself in full from the users of the service in practice it is applied within the limits set by the price policy which the government wishes to follow

An illustration of the use of the benefit principle to a non commercial activity is to be found in the theory underlying the gasoline taxes Automobile owners are assumed to be the chief beneficiaries of good roads Consequently it is expected of them to support road construction and maintenance through the gasoline taxes which they pay Yet even here where the relationship between the contribution and the benefit is somewhat more easily established it is not unknown for part of these presumably earmarked receipts to be diverted to other uses This legerdemain finds no support in the theory, but administrators scratching in empty purses or heeding the voice of political expediency on occasions, do not hesitate when hard pressed to ride rough shod over the best of theories

Today, the benefit theory tends to be applied in accordance with the following generalization In those cases where a reasonably direct relationship can be established between particularized government functions and individual benefits, an endeavor should be made to have the beneficiaries support these services through taxation

The *ability theory* offers an alternative method of distributing the tax burden It insists that justice obtains only when all contribute to the support of the state in accordance with their respective abilities Those with the broadest backs are expected to shoulder the heaviest loads while

those of lesser strength would pack burdens better suited to their less robust physiques Few contest the validity of this principle at least in theory Unfortunately this consensus disappears when the abstract principle is applied to particular cases Then opinions differ This is inevitable for if the apportionment of the tax burden is to be founded upon something other than the pragmatic test of whatever works best is best differences of opinion cannot be avoided For years the finest intellects have pursued the concept of justice without reaching an agreement to which everyone would subscribe The most that can be hoped for is that opinions will be imbedded in a solid foundation of honest endeavor to seek the truth

Today, income is accepted as the proper test of ability Consequently to the extent that the ability theory is used the taxpayer s contribution becomes a function of his income Generally speaking the larger his income the greater his tax liability But here again disagreement raises its head for there is no unanimity of opinion regarding the concept of income Does it include as the Supreme Court has ruled realized capital gains or should the receipt be recurring incident to the normal occupation of the receiver? Should income derived from the sale of personal services such as a doctor s fee or a laborer s wage be treated in the same manner as income from invested property? Should income be limited to monetary receipts only or should it include real income as well? In the United States the answers to these questions are to be found in the decisions of the Supreme Court and though one may disagree with the Court s verdict so long as the Court has made a decision it is binding until that time when the Court sees fit to reverse its position

Assuming that a technique has been developed for ascertaining the taxable net income of an individual, the next question is whether justice requires this income to be subject to progressive rates One school of thought which appears to be decreasing in importance believes that equity is more closely approximated when proportional rates are used This group holds that proportionality would not only succeed in having the wealthy pay more than the less fortunate but would possess the additional virtue of leaving everyone in relatively the same position after the payment of the tax as he was before To place a greater burden upon the wealthy than this they claim is but to penalize them for their superior ability They insist that it is not the function of the tax system to tamper with the present distribution of wealth and income They also believe that people share in the services of government in proportion to their income therefore a payment based upon a proportional contribution is not only more just but in the long run will prove less disturbing to the economy

The proponents of progressivity believe that society as a whole can minimize the sacrifice involved in the payment of taxes only when the

tax rate increases with an expansion in the size of the income They con tend that a progressive system of rates is the only assurance of an equi able distribution of the tax burden

Each dollar is of paramount importance to that third of the America families whose annual income is less than $780 a year Necessities la claim to every penny Each dollar taken as taxes from these people entail a reduction in their standard of living a standard of living which scarcel yields the bare necessities of life To forego these primary requirement involves a maximum of sacrifice on the part of these families As the siz of an income increases however the ability of the additional increment to satisfy wants diminishes This assertion although questioned by som is defended by the advocates of progressivity on the grounds that ma proceeds from the satisfying of necessities to the enjoyment of luxurie In short he perhaps unconsciously graduates his expenditures accordin to their relative importance to him, moving with an expansion of hi income from the fulfillment of his more vital wants to the gratifying c those of lesser importance To him who luxuriates on a yearly stipend c several hundreds of thousands of dollars an additional dollar is of littl importance compared to one who is compelled to draw his economic bel tighter to make ends meet on say several hundreds a year Technically this tendency for each additional increment of money to decrease in im portance as the number of units increases is called the diminishing utilit of the dollar

One postulate which is either explicitly stated or is implied by thos interested in minimizing the sacrifice of society is that the minimum c subsistence shall be excluded from all taxation This rests upon the as sumption that any demand made by the state upon the funds necessar to assure this minimum standard involves a sacrifice beyond the capacit of these people to endure Incomes in excess of this amount are to b taxed and at progressive rates When this is done the government takin those dollars which are used to satisfy the less important or even trivia wants, will be minimizing the sacrifice which society experiences whe paying its tax obligations

It should be noted that the sacrifice theory is supported by reasonin that is subjective in nature It seeks to distribute the tax burden on th basis of the psychological reactions of taxpayers to the taxes which the are called upon to pay If the same rate of taxation is to be applied t people of the same net income it must be assumed that individual behavio follows the same pattern an assumption which, at best, is questionabl Moreover, if the principle of the diminishing utility of the dollar be ac ceded to there would still remain the problem of objectively determinin the rate at which this phenomenon occurs And in the absence of objectiv criteria this must remain a matter of opinion And, finally the only sac rifice to which the theory refers is the *direct* sacrifice involved in turnin

over to the government part of one s income The effects of the rates in vogue on the business community or the compensating effects of government expenditures are not reckoned in these calculations A theory which fails to account for these *indirect* effects must be inadequate

If the canon of equity be approached as a problem in ethics rather than in psychology one can be more objective The ethical objective of a society is not merely to increase wealth but to increase welfare The justification of any act would be dependent upon whether it contributed to this end or not And the criteria of welfare could be stated objectively in terms of housing foods shelter leisure employment and educational opportunities This would not exclude a consideration of the sacrifice incident to the payment of taxes for that too must enter into the determination of welfare Inherently progressive rates would be no more acceptable than proportional rates Whether at any given time under some given set of circumstances progressivity would be held more desirable than proportionality would depend upon whether its acceptance assisted more than the acceptance of proportionality in achieving a higher degree of welfare

This method of analysis would pitch the arguments on a higher level of objectivity Investigations would not be limited only to speculating concerning the direct sacrifices involved but any inquiry if it is to be acceptable would of necessity have to analyze the economic effects of the tax system in use There would be little advantage in minimizing the direct sacrifice if it were at the cost of distressed business and widespread unemployment The canon of equity must be more then than a psychological exercise To be useful it must be the canon of equity tempered by the canon of economy

Conclusion

There are those who would dismiss the canons as of no practical import as nothing more than the playthings of academicians which help them while away the time To these same people taxation is but another page in the book of pressure politics They would reduce the principles of taxation to a single statement— Pluck the goose that squawks the least and grease the axle that squeaks the most And it must be admitted that the statement possesses the virtue of fetching simplicity But if taxation is to be something more than a blind striking of heads resting for its defense upon some 'hog trough philosophy, it must follow those principles which time and experience have proved best All will not be easy conflicts are as inevitable as are differences of opinions but the probabilities of approximating the goal of perfection will be far more favorable than they would be if the accumulated experience of students administrators and legislators were tossed on the ash heap as so much junk

CHAPTER 23

TAXATION AND SOCIAL CONTROL

In the preceding chapter, taxation as an instrument for the raising of revenue was distinguished from taxation as an instrument for the regulation of certain socio economic activities It was indicated that in many cases the line which separates these two functions is difficult to discern Often this line becomes indistinct losing itself in a twilight zone in which the white function of revenue raising is fused with the black of control forming a tapestry in gray Yet there are situations in which the two functions are sufficiently separable to permit a distinction In short the distinction is one of degree but this difference in degree is so marked in certain particular cases as to warrant assuming a difference in kind Hence if one will bear in mind that these distinctions are not absolute but relative then the following definition will prove useful If on the contrary the definition leads one to infer that all taxes can be catalogued under one or the other of two labels—regulation or revenue—nothing more has been contributed to the topic than a false impression A tax used for social control therefore will be understood to be an instrument utilized by the government to influence socio economic activity in certain specific ways regardless of the revenue which may incidentally be produced

When the government determines to regulate some socio economic activity through the exercise of the taxing power, the decision to use this medium may not have been a matter of free choice The absence of an effective alternative to taxation may be owing to the various constitutional restrictions which hedge about the area of free Congressional action Under the American constitutional system certain powers are specifically delegated to the federal government while others are reserved to the individual states or the people Hence Congress on occasions denied those powers which would permit it to move directly toward its objective is compelled if it is to reach its goal, to take the more indirect route provided by the power to tax This is not resort to subterfuge but intelligent response to necessity Furthermore the tendency on the part of the Court at least in the past to interpret very narrowly certain of the powers delegated to Congress leads this body into the practice of securing its ends by acting under some other power and frequently of the alternatives present the power to tax proved the most efficacious

In 1869 the Supreme Court in the Veazie Bank vs Fenno case (8 Wall 533 548) validated the right of Congress to use the taxing power to prohibit the issuance of state bank notes Quite clearly what Congress sought was the creation of a national system of currency and in order that this end could be achieved it was necessary to prevent the continued issuance of state bank notes The latter was accomplished by subjecting the issuance of these notes to a tax at the prohibitive rate of 10% This tax by making it unprofitable for the state banks to continue issuing their own bank notes left the field open to the federal government s national bank notes That the tax produced no revenue was of no consequence for that had never been its purpose it was sufficient that it succeeded in its main purpose which was to drive these state notes from circulation The Court in upholding this act of Congress said The power to tax may be exercised oppressively upon persons but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected

The manufacturers of oleomargarine had succeeded in improving the market position of their product through the introduction of a coloring which gave to the oleomargarine an appearance much like that of butter It was thought by some, possibly those deeply interested in the dairy industry that this colored oleomargarine would soon usurp the high position which butter occupied in the purchases of consumers Congress at this juncture for reasons that may more profitably be considered under a study titled Pressure Politics levied a tax of 10 cents per pound on oleomargarine colored to resemble butter The effect of this tax was to rob colored oleomargarine of any competitive advantage which it may formerly have possessed Here as was true in the Veazie Bank case the revenue which resulted from the imposition of this tax was both incidental and negligible The Court in rendering its verdict in the case (McCray vs The U S 195 U S 27) which grew out of this use of the taxing power said The decisions of the Court from the beginning lend no support to the assumption that the judiciary may restrain the exercise of a lawful power on the assumption that a wrongful purpose or motive has caused the power to be exercised

The point to be noted is that the Court [1] has supported Congress in its use of the taxing power to prohibit certain practices to restrict the sale of certain commodities and to improve the competitive position of certain industries The fact that the legislation was cloaked in the guise of a tax bill did not hide the undergarment of regulation from non legalistic eyes even though the outward habit of taxation was compulsory dress before the gentlemen of the Court And let it not be forgotten that ofttimes this

[1] The Court has not always been perfectly consistent in its attitude toward the use of the taxing power for purposes of social control See Hammer vs Dagenhart 247 U S 251 The Child Labor Case 259 U S 20

resort to disguise is no mere trick of wily charlatans but a practice which necessity has mothered into a political art

The fact that taxation has been used in the United States for purposes of social control ever since the inauguration of the American protective system does not mean that this practice has met with universal approval There have always been those who have viewed this policy with misgiving These opponents, for the sake of simplicity may be divided into two groups First, those whose objections are based upon the conviction conscientiously held and honestly developed that this use of taxation is based upon fallacious logic and ultimately will prove injurious to the country and second those whose objections are founded upon convictions which at best, are of questionable sincerity Quite often this latter group opposes not the use of the taxing power for purposes of social control but rather some *particular* use which would yield a result of which they do not approve

The first group which for the want of a better term has been referred to as the honest opposition insists that the tax system has a sufficiently important and onerous task when it functions as a raiser of revenue In securing the great sums which it is its lot to procure, a multitude of technical problems must be solved numerous conflicts of opinions and interests must be harmonized These are major problems in themselves worthy challengers of the most ingenious of tax administrators If in addition the tax structure be called upon to do double duty they believe that in time the structure will become so complex so unmanageable that it will fall of its own weight Furthermore if society is hampered by malpractices if evils cry out to the heavens for correction the only proper method of rectification is not to spend one s energy in futile pursuit of the bypaths of taxation but to attack directly One does not trim a poison ivy bush after it has come into full bloom what he does is to hack it out at the roots If correctives of a more permanent nature are to result the evils must be attacked at their source It is high time that the concept which insists that taxation is the panacea for all social ills be abandoned

Much of the opposition to the use of the taxing power for purposes of social control is not fundamentally honest In his endeavor to sabotage the ends sought the opponent frequently attacks the means employed, on the basis that this constitutes a perversion of the power to tax For example it was not uncommon for the processing taxes, in their heyday, to be subjected to the most vehement diatribes It was claimed that to make of taxation an accomplice in the act of crop reduction was an aggression against the laws of God and man Now this may or may not be true, but it is hardly fitting for one to damn, on the one hand this use of taxation and at the same time, plead the need of higher protective tariffs In both cases taxation was looked to as a means to be used for

improving the lot of particular American producers This practice of hailing and damning simultaneously should not be dismissed as a mere inconsistency of small minds but accepted as logic of a most incontestable type It reflects the old truth that it is often more expedient to attack the means to an end than it is to question the ends themselves Consequently in analyzing an attack upon the use of the taxing power for purposes of social control it should be ascertained whether it is based upon an honestly founded conviction or an opposition to the ends being sought

Should the use of taxation for purposes of social control be extended or should it be discontinued? Is it possible to reach some common ground of agreement relative to this problem? Probably the answers to these questions can best be found by applying pragmatic tests Granted that an agreement has been reached as to the ends desired then the use of taxation as the means would depend upon its efficacy compared to that of the other alternatives available If taxation proved incapable of getting to the root of the difficulty if it should turn out to be a cumbersome instrument then it would give way to some other more acceptable technique This procedure would not eliminate all differences of opinion nor would it succeed in harmonizing all conflicting interests but it would possess this virtue it would pitch the arguments on a higher plane of intelligent debate fact rather than fiction scientific analysis rather than folklore would then mark these discussions

Death Duties

Death duties is an inclusive term commonly used to designate two distinct taxes which become operative upon the death of an individual One the *estate tax* is imposed on the privilege of a decedent to transmit property at death It applies to the entire net estate as a unit regardless of the number of shares into which it may have been divided for purposes of distribution or the relationship of the various beneficiaries to the deceased The other the *inheritance* or as it is sometimes called the *shares tax* is levied on the privilege of the heir or legatee to receive the property It in contrast to the estate tax is assessed on the separate shares of the estate received by the beneficiaries and takes cognizance of the relationship of the recipient to the deceased In the United States the estate tax only is used by the federal government while the inheritance or the estate tax is employed by all but one (Nevada) of the state governments

The validity of treating death duties under a consideration of Taxation and Social Control may be questioned and rightly so These taxes which in 1936 contributed 4 5% of the total revenues collected by the national and local governments in the United States cannot be said to be fiscally unimportant It should be remembered too that in 1916 the federal government reacting to the uncertainties caused by the European War

instituted the estates tax to help defray the costs occasioned by the preparedness program While it is true that in 1926, the federal government through the development of a crediting device practically surrendered this field of taxation to the individual states, in 1933 when it was pressed for funds it turned again to the estates tax And to assure an adequate yield it instituted a system of surtaxes[2] reduced the exemptions[3] and increased the rates[4] Consequently, while the productiveness of death duties must be recognized the fact that the issues which are constantly being debated relative to these taxes are socio economic in character warrants treatment at this point

One argument advanced against death duties is that which holds the right to bequeath property to be a *natural right* and hence beyond the pale of taxation This argument which once occupied a position of high dignity owing to its ancient lineage has today fallen upon unfortunate times The right to bequeath property unlike the gentle rain does not fall from the heavens but stems from the earthly soil of society This right is not a right but a privilege which society sees fit to grant It finds its sanction not in some eternal universally applied principle but in the societal laws of a particular culture And since society grants this privilege it in turn has the right to set forth the conditions under which the privilege can be exercised Freedom to do with one s property as he alone sees fit is not democracy but anarchy Hence society when defining the conditions under which property can be bequeathed is not arrogating to itself an authority which is not its own it is doing nothing more than exercising a prerogative which it inherently possesses

The older claim that death duties abolish property rights of the individual with the intent to despoil the dead has been interred, the obsequies being performed by the courts Today the attacks launched against death duties are flanking movements rather than frontal assaults Opposition is no longer based upon a denial of the right of the state to prescribe the conditions under which property can be bequeathed but is directed at certain particular conditions which the state prescribes This may be stated as the Yes but type of argument the Yes being the right in principle to use the tax the but being incident to the specific manner in which it operates The chief accusation is aimed at the rates especially the rapidity with which they have been advanced in recent years To particularize the rates are held to be so excessive that they either destroy wealth or discourage its accumulation

[2] The surtaxes were an additional set of rates superimposed upon the rates under the 1926 law and against which the credit for state inheritance taxes could not be taken

[3] The exemption was reduced from $100 000 to $40 000 It should be noted however that in addition to this $40 000 credit is the exemption of the first $49 000 of life insurance

[4] Under the original act the rates progressed from 1% to 10% under the Revenue Act of 1935 the rates ranged from 2% on net estates of less than $10 000 to 70% on those in excess of $50 000 000

Do Death Duties Destroy Wealth?—If wealth be conceived of as concrete goods already in existence such as machines buildings or homes it should be obvious that these taxes do not directly contribute to their destruction It is not reasonable to presume that men would vent their resentment toward these taxes by running amuck burning buildings dynamiting machines or ruthlessly tearing down houses Therefore it cannot be in this sense that those who use the phrase destroying wealth intend it to be understood Rather destroying wealth must imply decreasing the amount of capital by interfering with its accumulation with the result that society is left in a less favorable position than it may otherwise have been

Do Death Duties Reduce the Amount of Potential Capital?

The payment of death duties involves a transfer of purchasing power from individuals or estates affected by the taxes to the government Although this transfer decreases the amount of privately controlled purchasing power it *pari passu* increases the volume of funds available for government use Therefore, the transfer in itself does neither expand nor contract the *total* volume of funds available for capital construction The effects, if any which the tax may have upon capital goods production will depend upon the ultimate use made of these revenue receipts If the taxes were used to finance the construction of hydro electric power plants or houses or bridges no reduction in capital construction would be experienced What in fact would occur is that the government rather than private enterprise would do the investing If on the other hand the tax monies were used to increase the wages of government employees or were utilized to expand the benefits being paid to the destitute, less would remain for capital investment The absence of death duties is no perfect guarantee however against a reduction in the volume of capital funds the beneficiary of a bequest may elect to spend his windfall to gratify all of those desires which were denied him in his former less affluent position

Do Death Duties by Necessitating the Liquidation of Large Estates Decrease the Total Volume of Capital?—The affirmative argument is as follows In those cases where the sum required to meet the tax liability is of considerable magnitude little remains to the subject of the tax but to liquidate the estate in order that ready money in sufficient quantities is forthcoming Often this occurs at a time when business is in the doldrums and the assets of the estate must be disposed of at unreasonably low prices This subjects the estate to an additional and unwarranted exaction which cannot be justified ethically In order that the necessary taxes can be raised the estate must be shattered into a number of pieces each of a sufficiently small size so that purchasers can readily be found for them Some believe that the ensuing loss of efficiency of the estate as an eco

nomic unit is the cost which this technique exacts Before accepting these claims as being necessarily true the following facts should be considered The government cognizant of the difficulties pursuant to a hasty disposal of an estate is willing at the request of the subject of the tax, to grant a period of 8 years duration during which arrangements can be made to carry out the sale of the assets in an orderly fashion This consideration obviates the necessity of a hasty liquidation of the estate in a depressed market Moreover if the estate should consist primarily of business properties the required tax money may be secured by disposing of shares in the enterprise to others This would make possible the tapping of the incomes of a number of individual investors and even though the unit purchase may be small in amount in the aggregate a sum adequate to meet the tax obligation could be raised

There is one manner in which death duties could affect capital accumulation But in order for this to occur the taxes would have to manifest their influence prior to the advent of death If men anticipating this levy should decide to spend rather than save their incomes for the immediate satisfaction of their wants, the size of the estates which they could bequeath would consequently be smaller And since it is savings which create the fund from which advances for capital equipment are made this choice to consume would be reflected in a diminution in the stock of capital goods Thus if it be thought that death duties are confiscatory and should be avoided through the expedient of increased expenditures for consumption goods society confronted by an inevitable reduction in its capital fund will be less well provided for in the future

There is an inarticulated major premise' which underlies many of the arguments advanced against death duties This premise if not of questionable validity is at least of such limited application that it should be investigated unless by implication it is given weight far beyond that which it warrants This premise claims that the chief force which motivates men in so far as their struggle for a fortune is concerned, is the desire to leave behind them a huge estate It is improbable that the behavior of all men can be explained as a reaction to some single stimulus What is more likely is that man reacts to a complex combination of stimuli Hence to attribute to this desire to bequeath a huge estate the distinction of being the *one* motivating force is either wishful thinking or a deceptive oversimplification The satisfactions which come to him who is eminent in some given endeavor, the sense of power which wealth makes possible the knowledge that he is *the* captain of industry all play their parts Probably the dominant driving force differs with different individuals and with the same individual under different circumstances

Finally it should be noted that the various arguments advanced against death duties could as well be used against many other taxes, especially

the income tax In short these arguments are not peculiar to death duties but rather are arguments against taxation in general Consequently the real issue is not whether death duties reduce wealth assuming that this phrase is given meaningful content but whether death duties do this more than do other taxes now in force

Some Affirmative Considerations —Many are convinced that the marked inequality in the distribution of income and wealth which characterizes modern American society stands as a constant threat to the preservation of the democratic way of life Although the percentage of the population which receives an annual income of say $100 000 or over is exceedingly small the power which this income bestows on the group far exceeds its numerical strength It is believed rightly or wrongly, that any socio economic system which places in the hands of a minority group the power to determine the destiny of the great mass of the people is no longer democratic but oligarchic Moreover they point to the fact that the economic position of this more favored group cannot be explained away entirely on the basis of superior capacity The larger portion of a huge income does not result from the sale of personal services but from the ownership of property Therefore a system of inheritance which permits the continued transmission of large estates perpetuates this un equal distribution of income In evidence they point to the fact that the disparity between incomes in the United States has not tended to de crease The rich seem to remain rich the poor poor Hence if a more equitable distribution of income is necessary to the preservation of democ racy (and this is a controversial claim) and if the bequeathing of estates is largely responsible for the continued unequal distribution of wealth then an effective means of correcting the situation would be to limit the right to bequeath through the use of death duties

Others thinking less about the relationship of the system of property rights to democracy center their attention upon the effects of the unequal distribution of income on the utilization of human and material resources They hold that society has not as yet reached that state of affluence when it can with impunity afford to waste its resources too many people still view hominy grits and hog meat as a Lucullian repast They object therefore on the basis of economic wastefulness, to a system of inheri tance which permits some scions of wealth to elevate self imposed unem ployment to the status of a dignified art These children of Crœsus nourish their whims on the product of society without *personally* con tributing to its creation The objection is not the vocalizing of a cantan kerous enviousness though that may account for the bitter comments of some but is rather the expression of awareness of the waste which this condition permits Manpower goes unused selling its heritage for a mess of pottage When this group spends to gratify some passing fancy it too frequently, directs resources from socially important into socially unim

portant channels Society needs the abilities of everyone too much to permit any group to escape its responsibilities in richly endowed idleness

The proponents of a more equitable distribution of wealth would view the problem also from the other side of the railroad tracks A more equitable distribution of income would offer the less fortunate a greater *opportunity* to develop their capacities It is an arduous task for one born to poverty to follow the long tedious path to professional accomplishment Even though nature may have endowed him with the hands the mind and the temperament of a surgeon unless he has the financial means for carrying himself through the many years of necessary schooling these attributes come to nought This is not merely a personal loss as tragic as that may be it is a social loss as well It reflects the failure of society to utilize intelligently a very limited resource—capacity for great things Therefore those who advocate greater equality of opportunity who believe that the sporting thing is to start all contestants from the same mark insist that a system of death duties coupled with a carefully thought out program of governmental expenditures is necessary if *equality of opportunity* is to be something more than a convenient cliché

Customs Duties

Customs duties or tariffs are taxes levied on the right to move certain designated goods across an international boundary line In the United States these duties affect only imports since the Constitution prohibits the federal government from taxing exports just as it also denies the use of these taxes to the individual states Customs duties are levied either at ad valorem rates—i e rates expressed as percentages of the value of the commodity taxed—or at specific rates—i e rates expressed as a given amount per unit of the goods taxed In some few cases both ad valorem and specific rates are applied simultaneously to a single import

The last hundred years have witnessed a decline in the importance of customs duties in the federal fiscal system Until the War between the States, the federal government relied upon the customs duties to supply the bulk of its receipts The Civil War however marked a turning point The courtship between government and business which had been fostered by the war culminated in their marriage and it was not long before this union gave the coup de grace to the theory that the primary function of customs was to raise revenue From this period until the World War, customs duties while doing yeoman service as a protector of American industry contributed about 50% of total federal receipts By 1935, however, this percentage contribution had fallen to about 10%

If it be accepted that the principal function of customs duties is to raise revenue then it is mandatory upon the legislature that it frame the tariff laws so as not to discourage the continued importation of foreign

produced goods This can best be accomplished if commodities of wide spread consumption such as tea and rubber which are not domestically produced are selected to bear the duties In the absence of acceptable substitutes these goods can bear a comparatively high rate of taxation before the volume being imported is seriously affected Since they would not directly compete with the products of American industry there is less likelihood of their becoming an issue in the game of tariff politics If on the contrary the commodities be competitive with domestic products their continued importation should be encouraged for otherwise no revenue will be forthcoming This can be achieved by maintaining duties of sufficiently low rates so that imported goods are not entirely robbed of their competitive advantage Furthermore the commodities selected for taxation should be carefully chosen and limited in number If the list be too lengthy if it be marked by a variety of rate schedules it becomes difficult and expensive to administer

If the customs duties assure American industrialists a domestic market protected against foreign competition then these taxes are being used as an instrument of social control The power to tax is being used not primarily to produce revenue but to limit the area of competition the cruder form of international individualism is refined to a purer American variety Incidentally this Americanization of competition frequently proves most profitable for those industries which find a snug haven in harbors protected by substantially constructed tariff sea walls The technique employed to insulate the American market from the machinations of foreigners is that of raising the tariffs until they constitute an insurmountable wall coextensive with the frontiers of the country If the masonry has been so well performed that total exclusion results the ideal of protectionism obtains Ordinarily however the wall is neither so high nor so solidly constructed as to achieve this perfection Usually the barrier is of just that height necessary to exhaust most anyone who attempts to scale it The effort expended by the foreigner in climbing the wall weighted down as he is with the burden of his goods saps his strength leaving him greatly weakened for the competitive struggle which he must subsequently face Thus having either eliminated or greatly weakened foreign competition the American producer is now in a position to secure higher prices The taxing power has been so used as to grant to these favored industries what amounts to a bounty

The increase in price which the restriction in supply has occasioned is in the nature of a tax upon consumers but unlike an ordinary tax, this levy possesses this distinctive quality instead of the tax swelling the receipts of the government it accrues to the protected industry There may be good and sufficient reasons why this protection should be extended Possibly young industries require the guiding hand of a paternal government through the years of their infancy and adolescence It taxes one s

credulity, however, when these industries reach maturity when their faces are covered with a heavy black stubble to accept as true their plea that the withdrawal of the parental hand of government protection dooms them to extinction The danger in the infant industries argument lies in the reluctance of many industries to abandon their swaddling clothes even after their torsos bulge with the muscles of fully developed manhood But if real reasons rather than persuasive reasons do exist which justify this special treatment then there should be no hesitancy about making known what this consideration costs the public It is not quite cricket to foster the belief that you can have your cake and eat it too

The tariff on sugar is illustrative of this problem It has been estimated that the duty on sugar costs the average family in America some $10 per year This contribution is made in order that the sugar cane grower of Louisiana and the sugar beet raiser of Utah can continue to produce sugar free from what is termed destructive foreign competition The issue shorn of all unnecessary verbiage can thus be posed Is it worth $10 per family per year to insure these sugar growers protection from foreign competition or is it not? If the public is convinced that an American sugar growing industry is vital to our national well being then by all means encourage its growth and development But if the protection finds its raison d etre in the necessity of preserving the American standard of living for the Negro field hands of Louisiana or the itinerant Mexican workers of Utah it may prove the better part of wisdom to question the validity of these claims before one plumps for their adoption It may be found in fact it probably will be found on closer inspection that many of the advantages claimed for protectionism is but pap prepared for popular consumption by those industries which have much to gain personally from high tariffs In short, if the power to tax is to be used as an instrument for granting special consideration to selected American industries some endeavor should be made to inform the public of what this protection costs Armed with this knowledge the public could then make its decision between more or less international trade with its eyes opened

If the attempt is made to have the same tax both protect domestic industry and yield revenue the endeavor is destined to become impaled on the horns of a dilemma This is inevitable for the two objectives are contradictory Protection depends upon restricting the flow of imports, revenue, upon continuing the flow of imports To the extent that the tax succeeds in protecting American industry, it fails to be highly productive of revenue to the degree that it yields adequate revenue it fails to protect industry In practice this Gordian knot is severed by subordinating one objective to the other in response to the exigencies of the situation

The Balkanization of the States[5]

That form of provincialism which makes of sectional peculiarities cherished possessions and which at one time manifested itself in a manner of speech a turn of phrase or in a specially prepared dish is today taking a new form—economic insularity In spite of the fact that the Constitution explicitly forbids the individual states from using tariffs nevertheless practically every state through the medium of the power to tax has raised numerous barriers against the free interstate movement of goods Thus what was once the largest contiguous free trade area in the world is now in the process of becoming Balkanized

Just as the American producer sought a market free from the threat of foreign competition the local producer is now seeking to exclude the competition that comes from across the state boundary line In many of the states where the dairy industry constitutes a potent force the power to tax has been so used that for all practical purposes margarine can no longer compete with butter[6] Michigan favors its local wine producers by extending to them preferential tax treatment Wine in this state made from home grown grapes is subjected to a tax of 4 cents the gallon while wine made from grapes without the state pays a tax at the rate of 50 cents per gallon Alabama smiles upon home grown materials destined for the manufacturing of liquor Each liquor manufacturing plant is subject to a tax of $1 000 but the legislation has been so framed that if the materials used originate within the state the tax falls to $25 per plant

This states rights form of economic nationalism did not just drop into the country s lap It is the offspring of the doctrine of national protectionism and the appeal of patronizing home folks It doesn t require the stride of one shod with seven league boots to step from national to state trade restrictions Given a sufficiently powerful economic group conscious of where its interests lie the state legislature will soon either be forced or cajoled into acquiescing in its demands It is not strange that this instrument of taxation which has proved so efficacious in the national field should be turned to in the state field It is regrettable however that the power to tax can insulate the several states against the life giving current of commerce it is tragic too that this great free trade area which ac

[5] See *Tax Policy* May 1939 for a discussion of the many forms which these restrictions take

[6] Thirty states levy excise taxes, or license fees or both on oleomargarine The rates are so high as to be prohibitive in some of these states and from the small amount of revenue derived in the others it appears that the tax is very effective in limiting the amount of oleomargarine consumed In the cotton and cattle producing states oleomargarine made from cotton seed or animal fats is exempted In the cattle producing states outside the Cotton Belt however cotton seed is penalized alongside cocoanut and other foreign oils by an imposition of an excise on all margarine not containing a substantial percentage of animal fats From *Tax Policy* Mar 1939 p 2

counts so largely for the growth and development of the nation now faces Balkanization In this case the power to tax is being used as an instrument of social control to achieve an anti social end

Social Security Taxation[7]

The Social Security Act of 1935 as amended August 1939 seeks through government assistance to assure the family and the individual greater security against many of the hazards which in the past they have had to face alone The act provides for an old age and survivors insurance program to be administered by the federal government and offers to the states, federal cooperation and financial assistance in creating unemployment insurance systems in extending financial aid to the needy aged needy blind and dependent children in supporting services for maternal and child health and maintaining health and vocational training centers The act recognizes that numerous honest and hard working people who though conscientiously endeavoring to put into practice those many maxims found in the McGuffey readers have had nothing more to comfort them when faced with those numerous risks to which man is heir than the knowledge that for all their sacrifices they are utterly incapable of meeting the exigency successfully It avails one little to prepare laboriously for the inevitable rainy day only to find the umbrella washed away in a deluge And the man of meager means cannot build an ark the best he can hope for is a house on ground high enough to weather the heavy rains of fall and spring The act breaks with that older concept which held that poverty or unemployment in old age was a punishment visited upon one because of some personal delinquency it accepts these misfortunes as a social responsibility for the meeting of which the lone individual is ill equipped

That section of the Social Security Act—old age and survivors insurance—which is exclusively the concern of the federal government, is financed from the receipts of two taxes an income tax and an excise tax These are levied at the same rate and fall equally upon employers and employees The reason for designating by two distinct names these taxes which for all practical purposes are identical was to avoid an anticipated constitutional difficulty By calling the tax which fell upon the employer an excise tax there was given to this levy a constitutional acceptability which in all probability would have been lacking had it been referred to by some other name The base of the tax is the annual wage received by the employee, although in computing the wage that part of the yearly recompense which is in excess of $3 000 is not included Generally speaking all employers and employees engaged in industrial or commercial pur

[7] It is not the intention to treat the Social Security Act completely at this point This shall be reserved for the chapter Toward Social Security Only certain of the fiscal problems will here be dealt with

suits are subject to the tax[8] The rate of the tax for both employers and employees is 1% until 1943 2% from 1943 to 1946 2 5% from 1946 to 1949 and 3% thereafter It is the intention of the law that the tax falling upon the employer shall be borne by him, just as the tax paid by the em ployee is assumed to be his contribution in support of this social program The responsibility for making the necessary tax returns to the federal government is upon the employer The taxes collected flow into the general fund of the treasury and under the amendment of 1939 Congress appropriates a sum equal to these taxes to the old age and survivors trust fund[9] From this fund the benefits are paid to those who are eligible to receive this insurance

In contrast to the old age insurance program there is no nationwide system of federal unemployment insurance What there is is 48 state systems of unemployment insurance It is the purpose of that section of the Social Security Act which treats of unemployment insurance to en courage and assist the individual states in their endeavor to initiate and develop their own systems and to set up minimum standards to which the state systems will conform The method used by the federal government to speed up state action was mildly coercive in that it employed the taxing power to achieve its ends A federal tax of 3% which is in addition to the taxes paid under the old age insurance program is levied upon payrolls of those covered industries which employ 8 or more workers[10] In ascer taining the amount of the payroll subject to the payroll tax the amend ment of 1939 provided that only the first $3 000 of an annual wage would be included Thus a business man who employed 10 men at an annual wage of $4 000 each would pay a tax on a total payroll of $30 000 How ever if the business be located in a state which has an accredited unem ployment insurance system, the employer is permitted to take as credit against his federal payroll tax the taxes which he is compelled to pay under the state unemployment system so long as the amount taken as a credit does not exceed 90% of the sum due the federal government Since this arrangement requires the employer to pay the tax in any event this crediting device acts as an inducement for the state to inaugurate its own unemployment compensation system If the state should fail to do so the employer though paying the tax to the federal government would get no protection for his employees during periods of unemployment

A Board of Trustees consisting of the Secretary of the Treasury the Secretary of Labor and the Chairman of the Social Security Board is

8 The law specifically enumerates the occupations which are not covered Some of these are farming domestic service in private households fraternities teaching federal state or municipal jobs

9 This trust fund replaces the old age reserve account which was created under the original act

10 With some few minor exceptions the occupations covered by unemployment insur ance are the same as those covered under old age and survivors insurance

responsible for the management of the old age and survivors trust fund In addition to acting as custodians of the fund the Board of Trustees reports to Congress at stated intervals on the operation and status of the trust fund That part of the fund which is not required to meet current withdrawals is invested either in interest bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States

It is customary to refer to the various levies imposed by the Social Security Act as taxes yet it may be questioned whether they are in fact taxes in the sense in which that term is commonly conceived If one were to adhere strictly to the definition[11] which holds a tax to be a compulsory contribution made to the government to defray the costs of those state functions *which do not involve a quid pro quo* the Social Security payments would by definition be excluded from this category The assumption which underlies the act is that these contributions, like insurance premiums are savings placed in the hands of a custodian in this case the government which are ultimately to be returned as benefits to those participating in the program If a less rigid definition be accepted these contributions may then be called taxes applied in accordance with the benefit theory[12] Although this matter of definition may appear to be nothing more than the struggle of a lexicographer giving birth to a gnat under the American constitutional system such distinctions are of vital concern The acceptance or rejection of the constitutionality of an act of Congress may depend upon just such an interpretation An act of Congress which is held to be the exercise of the taxing power may weather a court battle unscathed Let it be interpreted otherwise and it may be done in

Whether these contributions are taxes or are not taxes, one fact stands clear the taxing power is making it obligatory upon many millions of people to save Through the instrumentality of taxation part of the income of employees in the covered industries is being taken from them, retained in the form of government securities by the Board of Trustees of the old age trust fund, and ultimately returned to them or their heirs The choice of whether they will or will not save no longer rests with these workmen There are many workers whose incomes are so small that any savings entails reductions in their present standards of living the sacrifice of some necessities of life Yet these unfortunates must make their contributions Possibly the corrective needed in these cases is not to exempt them from the operation of the act but to seek ways to increase their incomes There are some who believe that this siphoning off of con

[11] Professor E R A Seligman defines a tax as compulsory contribution to defray the expenses incurred in the common interest without any reference to particular advantage accruing to the taxpayer

[12] See L P Rice Financing Social Security by Means of Pay roll Taxes in Tax Policy League *How Shall Business Be Taxed* (Tax Policy League New York 1937) chap 11

sumers purchasing power during a period of depressed business is inadvisable The weakness of this contention lies in seeing the seen but failing to see the unseen The money flowing into the Treasury moves back into the current of expenditures either as benefits paid to the beneficiaries under the system or if the receipts are invested in government securities the government spends the funds accruing to it from the sale of its bonds In short there is no net loss of purchasing power as a result of this transaction It is true that the money may be spent for things different from those which would have been purchased had the transfer not occurred But whether the results of this change in the direction of demand will be socially advantageous or not will depend upon the effects the expenditures have upon the total volume of production and the distribution of these goods and services among the people

Conclusion

Although it is generally conceded that the primary function of taxation is to raise revenue its application to non fiscal fields is increasing This has been less a matter of choice than of necessity What may appear to be the logical easy means of achieving some social objective ofttimes cannot be used owing to the constitutional limitations which hedge about free Congressional choice Hence Congress denied the more direct route will take the more circuitous path to reach its goal How far Congress will be permitted to go in using the taxing power for purposes of social control will in the first instance depend largely upon the composition of the Supreme Court from a long run point of view it will be determined by the will of the people or possibly what is more accurate on the will of that part of the people that knows what it wants and how to get it

CHAPTER 24

PUBLIC BORROWING

How Government Borrowing Differs from Private Borrowing

When a privately owned business enters the capital market to secure funds through borrowing it does so because it anticipates rightly or wrongly a profitable employment of this money It is assumed at the time the loan is granted that the funds will be so used as to yield a return sufficient to meet the interest charges and to repay the principal of the loan and in addition to return to the owners of the business something over and above these two costs The government on the contrary customarily borrows in order to invest in those types of activities which although of great social value need not and generally do not yield a direct monetary return [1] In a privately conducted business then recourse to the loan market is in response to the profit motive the initiative resting with the entrepreneur who acts when in his judgment the future augurs well for business opportunities The government uses the loan market for a variety of reasons but the desire for a direct monetary gain seldom if ever constitutes one of these

When a private business borrows particularly in the case of long term credits it is customary for the loan to be secured by the pledging of specific pieces of the borrower s property as collateral [2] Thus a railroad company when issuing bonds will include in the bond contract a clause granting the bondholder in event of default the right to proceed against the company by laying claim to those specifically designated pieces of property which the company has pledged as collateral While it is true that in practice this protective device has at times proved meaningless owing to the fact that the properties so pledged usually are valuable only as long as they constitute an integral part of a functioning company, the device nevertheless tends to be accepted by security purchasers as evidence if not a perfect guarantee of the good faith of the company The one consideration however which supersedes all others in determining the willingness of a creditor to lend his money is his evaluation of the company s prospects of profit If future earnings appear reasonably cer

[1] There are certain self liquidating and commercial projects instituted by the government which run counter to this general statement It is customary in these cases for the government to charge prices sufficient to cover the costs of rendering these services

[2] There are occasions when businesses of long standing or of excellent repute issue credit instruments without including such a clause in the contract

tain adequate credit accommodations usually can be found In contrast the government does not simulate the technique of private business It bases its request for funds upon two factors primarily the confidence of the lender in the integrity of his government and his knowledge that the government has recourse to the taxing power to raise the funds necessary to service its obligations If a private business should fail to honor the conditions set forth in the bond contract the creditors can seek relief in the courts If on the other hand the government should refuse to meet its obligations little remains to its creditors but to secure peacefully or violently another government more receptive to the demands of its security holders

The distinction between private and government borrowing is reflected too in the accounting methods used to portray the financial position of each The federal government s accounting system rests upon the assumption that there must be an annual balancing of expenditures and receipts [3] In striking this balance however it has not been the practice of the national government to distinguish current from capital expenditures All expenditures regardless of the purpose for which they have been made [4] are expected to be met from current receipts if the budget is to be kept in balance Thus if the government should spend in some fiscal year $10 000 000 for the erection of a public building this entire amount constitutes an expenditure for that given year even though the life of the structure may be estimated at 50 years This method of operating under a single budget which draws no distinction between current and capital expenditures is known as *the unit system* Unlike the government private business recognizes that current expenditures and capital outlays are not as two peas in a pod and consequently, distinguishes the one from the other Capital outlays are presumed to secure assets whose useful life extends far beyond the one year' period of accounting upon which current outlays are based The annual recurring costs which such capital outlays engender are limited to the interest and amortization charges And it is these costs alone which business holds to be current costs occasioned by the borrowing and hence to be met from current receipts Therefore in private business a deficit means not that the company has spent more than it has taken in in any given year but that its current expenditures are in excess of its current receipts The federal government in its failure to distinguish current from capital expenditures experiences a deficit whenever its expenditures for any given fiscal year regardless of the purpose for which they were made exceed the receipts of that specific year

[3] See G H Hildebrand Jr Public Investment and Capital Budget and Mark Massell Some Aspects of Capital and Current Budgets for the Federal Government both in *Plan Age* October 1939

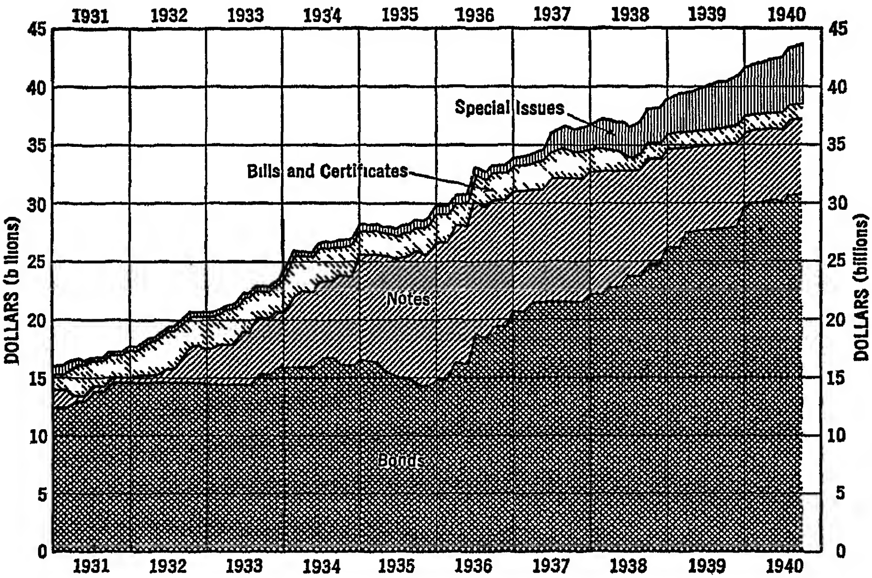
[4] Expenditures may be distinguished on the bases of whether they are ordinary emergency capital loan advances or subsidies

George H Hildebrand, Jr writing in *Plan Age* for October 1939, argues that the present budget should be divided into two budgets in recognition of the distinction between ordinary and capital expenditures One budget would present the fiscal plan for the year dealing with ordinary operating expenses and revenues—an operating budget The other would concern the long run investment plan for the nation and would include the capital expenditures of the government to be financed by borrowing In the operating budget there would be included all revenues from public assets of all kinds together with general tax proceeds Outlays would con

CHART 5[5]

COMPOSITION OF INTEREST BEARING PUBLIC DEBT OUTSTANDING

(Daily Statement Basis)



sist of the ordinary departmental expenses service on the debt, and depreciation charges for all state owned assets In the capital budget income would consist of the depreciation charges made in the operating budget plus the proceeds of newly floated loans while expenditures would include outlays for the acquisition of new assets and for the maintenance of old '

Various advantages, it is claimed would result from the acceptance of this change in budgetary procedure 'The investment or capital budget would function as a balance sheet recording public wealth offsetting public debt Capital expenditures would no longer appear in the operating budget and what is now termed the deficit would be substantially reduced Durable improvements owned by the government would be given account

[5] From Bulletin of the Treasury Department October 1940 p 18

ing recognition both for valuation and depreciation and the public debt would then be in large part offset by the addition to public wealth incident to its creation Moreover the change may affect the attitude of people toward the national debt At present, in the absence of an enumeration of the assets which the government has acquired through its loan financed capital outlays the debt to many persons is but a grim reminder of a profligate past a past in which incomprehensible sums went for nought If therefore the government were to follow the practice of private business and were to present the assets which these expenditures have secured it is conceivable that the psychological reaction of the people to the debt would be changed

To some the proposal to abandon the single budget is a trick of slick politicians to cover up shady practices It is a resort to low cunning to secure a balanced budget without imposing the concomitant sacrifices involved in higher taxes or decreased services This accusation appears less an attack upon the principle under consideration than upon those administering the government

A more serious problem which must be faced in any endeavor to institute a capital budget is that involved in the use of the term asset Since many probably most government capital outlays yield ' social utilities [6] rather than direct monetary returns it would become necessary to develop some acceptable technique for ascertaining their dollar value In the absence of a profit in the business sense the capitalization of earnings method would not be available It has been suggested however that the government could as does private business in those cases [7] where no precise value expression can be assigned to an asset enter the acquisition at cost and depreciate it according to some formula Excluding direct money income producing projects then the issue it seems would revolve about the determination of the cost of the asset and the agreement to be reached on what constituted an acceptable formula

Furthermore the capital outlays will occasion an increase in the debt which must be serviced and serviced in dollars As the debt mounts the carrying costs increase The funds to meet the claims of the bond holders must come either from the income which the projects themselves directly produce or from general taxation The self liquidating undertakings would on this issue, raise no insurmountable obstacles But what of the 'social utility producing assets? It is held that since they produce no direct monetary return the taxpayer is called upon to carry a heavier tax burden Whether the tax load would increase in size however would depend upon the effect that these expenditures would have upon the size of the national income Some expenditures although not producing money returns directly may be income increasing in the sense of stimulating

6 Bridges dams parks for example
7 Railroad stations warehouses fleets of delivery trucks

productive activity expanding the national income and stimulating the flow of taxes Thus it would appear that if the capital budget were to be accepted and if mounting interest charges were not to jeopardize the financial structure of the country borrowing for social utility creating purposes could be justified only as long as they were income increasing

Anticipatory Borrowing

One purpose for which governments borrow is to anticipate tax dates Although there is a constant stream of revenue flowing into the treasury the flow itself is not even There are certain periods during the fiscal year —tax dates—when this stream swelling to flood like proportions over flows its banks just as other times the waters subside until nothing more than the river bed is covered Thus March the month in which the income tax falls due is a period of rising revenue A similar situation holds in the fiscal affairs of states and local governments for here too are certain periods of relatively short duration during which the bulk of taxes is paid Governments cannot idly await these tax dates they have financial obli gations to meet daily economy demands that bills be paid within the discount dates and employees expect their salaries on time As a result of this situation there is no continuing equilibrium between receipts and expenditures either one or the other at any given time tends to be in excess It is to assure adequate funds during days of drought that short term borrowing [8] is resorted to To illustrate the federal government may have heavy expenditures during January and February expenditures which greatly exceed the revenues received during these months The opposite situation may be true during the month of March To provide itself with funds during the lean months the government will issue short term obligations dated so as to mature during March Thus the excess of receipts accruing during the income tax period can be used to pay off the maturing short term notes Thus the government by availing itself of this opportunity has been enabled to smooth out the flow of receipts and expenditures And furthermore, it has protected the banking system against being subjected to heavy seasonal withdrawals and deposits

This technique of financing does not necessarily increase the size of the national debt any more than short term borrowing by a private business concern expands its funded indebtedness An expansion in the national debt would be occasioned only if the anticipated tax receipts failed to come forth in the expected amounts for in this event the tax receipts would be insufficient to retire the outstanding short term obligations

While there is general agreement that anticipatory borrowing is good fiscal practice there is one danger which must be guarded against The danger lies in mistaking a continuing deficit for a temporary one and being thereby misled continuing to finance the deficit through the issu

[8] Treasury bills or notes of several months duration are used

ance of short term obligations If the government should fall into this error a misleading impression of the costs of this debt is created There are many investors who would be willing to hold short term obligations even though they bear very low rates of interest but the same people would be most hesitant to accept the same level of rates on long term bonds The investors know that the longer the life of a bond the more difficult it becomes to foretell the situation which will exist at the time the bond matures The rates which are offered on short term securities are not sufficient to induce them to accept the risk If the government should continue to procure its funds through the issuance of short term obligations a large floating debt results and if orderly financing is not to be abandoned a refunding operation is inescapable Otherwise the out standing obligations would become so numerous with so many varying ma turity dates that the debt would prove unmanageable When the attempt to replace the short term with long term obligations takes place it may then be found that a much higher rate of interest is compulsory if the action is to be carried to a successful conclusion The nation may suddenly awaken to the fact that the cost of its debt has trebled overnight

The point to be established is this anticipatory borrowing is permissible as long as it anticipates but when it becomes a cloak to cover what is truly the financing of persisting deficits by the issuing of short term obli gations then danger lies ahead

Borrowing for Non Recurring Purposes

This type of borrowing is engaged in by governments when they deem it advisable to finance some public project through loan finance rather than taxation To illustrate a small town may find that it becomes neces sary every 20 years to replace its outmoded school building If it be assumed that the project will cost some $75 000 and that it can be com pleted within a single year one of two methods of defraying the costs could be used One alternative would be to meet the entire expense from taxation within the year of construction If this course were followed an unprecedented increase in the tax rate for that year would be unavoid able The other alternative would be to raise the money through borrow ing If the bonds were issued for a period coextensive with the life of the building the annual increase in taxation would be limited to the annual service charges on the debt Thus rather than overweight the tax load in any single year the burden has been distributed over a longer interval of time Having limited the life of the bond so that it does not exceed that of the building the indebtedness will have been paid off by the time a new building is needed

If borrowing is the financing method to be used several pitfalls must be avoided First the expenditure must be non recurring that is it must not be an expenditure which the community will be called upon to make

annually or even every few years If the community should resort to the loan markets to finance its recurring expenditures a constantly mounting public debt will result The awareness of many of the people of what is happening will be dulled by the opiate of an artificially maintained low tax rate This seeming feat of having one s cake and eating it too is accomplished by raising in taxes not the entire amount being spent but only that fraction necessary to meet the carrying charges on the debt incurred It is a clever artifice which for the time being creates the illusion of great governmental activity at insignificant cost The day of reckoning however is inescapable Ultimately the government will no longer be able to postpone the increase in taxes made necessary by the mounting interest and amortization costs The increase in the rates must be great for not only will the current costs of government have to be met out of current receipts but the servicing of the expanded debt will lay claim to an additional part of the taxpayer s income

One is left with the problem of distinguishing non recurring from recurring expenditures if the aforementioned pitfall is to be circumvented Frequently the line of demarcation appears most uncertain and at best arbitrarily drawn nevertheless it may be of some assistance if the following general principle is accepted as a guide Expenditures which appear annually in the budget are by that very fact recurring and as such should be financed from current taxes expenditures which occur irregularly should be held to be non recurring and for that reason may be financed by borrowing

It must be borne in mind however, that this suggested method of distinguishing these two types of expenditures is usable only within limits Over a period of time an expenditure, originally held to be non recurring may appear with such increasing frequency in the budget that it can no longer be classified under its former category Constant vigilance must be exercised unless the true character of any given expenditure escape detection What of those expenditures which though appearing with regularity do so only at infrequent intervals? Are they non recurring or recurring? No definitive answer can be given to these queries The hope is that experience will so equip the administrative officials that skill and intelligence will mark their handling of these issues

Borrowing for Emergency Expenditures

Regardless of the high degree of intelligence exercised by fiscal administrators situations will arise that call for government expenditures on a scale that could not have been anticipated For example in September 1938 New England was lashed by an unprecedented hurricane So foreign to these states was this phenomenon of nature that no person living could recall a similar visitation Naturally, no allowance had been made in the budgets of the states and communities to repair the damages wrought In

creased taxes could be had only after legislatures were called into session and tax systems were revised When confronted with a situation of this type borrowing offers a speedy and efficient method of obtaining the much needed funds Thus it happens that after budget estimates have been carefully worked over and taxes skillfully adjusted some unforeseen incident will play havoc with the nicely adjusted balance that the fiscal administrators have established between receipts and expenditures The loan market offers the most accessible haven of refuge in cases of this nature

One additional illustration may be permitted Although the debate as to the proper role borrowing should play in war finance continues unabated there is one aspect of the problem which legitimately fits into the present discussion Today when war strikes with the speed of a dive bomber when the appetite of Mars seems insatiable governments if they are to resist must have funds immediately and in astronomical amounts To readjust a peacetime fiscal structure to meet the demands of a war situation is time consuming Legislatures must convene revenue bills must be intro duced and debated and agreements reached before an acceptable tax bill can be enacted into law The effects of the new legislation may not be felt for some time In the interim the emergency is not abated funds must be available To protect itself against an insufficiency of funds during this interim period the government will enter the loan market and secure the credits necessary

Borrowing for Capital Outlays of a Commercial Nature

A government may borrow to invest in publicly owned commercial enterprises without necessarily entailing any increase in the burden of taxation Like a private corporation the state may secure the initial capital by floating long term bonds in the loan market The funds derived from the bond sale are used to procure the elements necessary to bring into existence an operating business unit say a street railway system Whether this public business will be self supporting or not depends both upon the accounting method adopted and the price policy followed If a sincere attempt is made to ascertain all the costs involved in the operation of the enterprise not forgetting the interest and amortization charges upon the original bonds and a price policy is instituted which will assure a yield sufficient to cover these costs then there would be no need to seek addi tional funds from the general treasury of the state In short the project becomes self liquidating the users of the service contribute through the prices they pay enough to cover all the costs incident to the creation and maintenance of the project

The self liquidating theory has often been observed more in the breach than in the observance Frequently pressure groups consisting of the beneficiaries of the service attempt to compel or persuade the authorities

to modify their price policy so that the service will be offered at something less than cost If the authorities should bend under the pressure the resulting deficit would have to be made up from general tax receipts The contribution made from the general tax fund constitutes a subsidy to the users of the service Now there are cases when social policy justifies the extension of a subsidy but if this practice is to be resorted to the tax payers should be made aware of the fact

Compensatory Borrowing

There are those who maintain that when private enterprise fails to make investments in sufficient magnitude to insure society against the ravages of unemployment it evolves upon the government as a social duty to compensate for the decline in private investment activity by increasing its borrowing and expanding its capital investments The proponents of this theory comprehend the significant function played by the investment process in an economy which saves a large part of its income Unless the savings which are annually made move back uninterruptedly into the stream of purchasing power via the investment outlet society experiences a decline in business activity Savings may be placed in banks but that act alone does not guarantee their employment Whether they will be utilized for the purpose of creating goods and services or will stagnate as excess bank reserves will depend upon the willingness of business men to make investments

This intermediary step—investment—which lies midway between savings and production is often particularly in times of prosperity lost sight of The demand by private business for credit accommodations is so active that the saving investment and production process appears to be automatic It is not until enthusiasm for tomorrow blows cold that the importance of the investment step becomes obvious Therefore if private enterprise hesitates to move funds into production via the bridge of investments, then someone else must accept the obligation and that person is the government If this is done so these advocates hold production will be secured against a precipitous fall and, in consequence employment will be maintained

Compensatory borrowing may be analyzed from either one of two points of view first as a short run venture incident to a cyclical downswing in business, second as an inevitable concomitant of a future characterized by widespread business stagnation In the first instance government borrowing and spending are supposed to be temporary expedients, limited to that period of time necessary to restore the confidence of private business sufficiently in its more immediate future so that it will take hold with a reawakened vitality and carry the economy forward to a full and sustained recovery It is this type of government action which is known as pump priming In the second interpretation public investment is looked to as

the instrumentality which is to save the economy from the prolonged period of business stagnation which some believe we now face[9] Public investment is to compensate for the expected decline in private investments induced by the decrease in the rate of population growth the disappearance of the physical frontier the increasing rigidity of the price mechanism or some combination of all of these

The first of these two aspects of government borrowing has already been touched upon in the chapter treating of Government Expenditure The topic however warrants a more extended treatment The proponents of pump priming hold that it is not necessary to balance the budget annually This school of thought maintains that those who hold a yearly balance worth striving to achieve have failed to grasp the relationship which exists between the government economy and the private economy Those adhering to the compensatory theory are convinced that government investments are inextricably tied in with the total economy and in consequence should be so directed as to buttress private investments If this point of view is accepted an annual balancing of the budget ceases to be of vital concern Government spending becomes a function of the business cycle expanding when private business activity contracts contracting as private business activity expands It suffices if the budget is balanced not each and every year but over the period of a major cycle

If government spending is to act as a compensating device the money poured into the economy must constitute a net addition to purchasing power In order that the expenditures made will prove expansionary in character the money must be derived from funds which otherwise would go unused This objective severely limits the use of taxation If taxes were used and if the tax structure were so constituted that major reliance was placed upon excise taxes little more than a redistribution of purchasing power would result Taking funds from one group who would have spent the money in any event and turning the dollars over to some other group to spend does not increase the total amount of purchasing power[10] If income taxation were the principal source of funds then a net addition to purchasing power could result The probabilities would favor the assumption that wealthy people save some part of their large incomes and also that part of their savings in a time of depression would be stagnating in the banking system Therefore if that portion of this group s savings which is not being used were rechanneled via the treasury of the government into productive use total purchasing power would be ex

[9] A brief lucid attack upon the concept of a 'Mature Economy is found in *The Letter of the National City Bank of New York* Apr 1940 pp 44 47 Support of the concept can be found in A H Hansen *Full Recovery or Stagnation* (W W Norton & Co N Y 1938)

[10] It is conceivable that some of the recipients may spend their newly acquired income much faster than it would have been spent by the persons from whom it was taken This would tend to increase purchasing power

panded However the volume of funds that could be obtained in this manner would hardly be adequate If the increase in total purchasing power is to be of economic significance it must be of a sufficiently great magnitude to be of strategic importance The only effective means of expanding the purchasing medium adequately is to call forth those funds which have beat a retreat from the marts of business and if this is to be accomplished it must be done through public borrowing The government by offering its securities in exchange for a loan of this lethargic credit can through a program of public works pump the money back into use

However in spite of the high hopes that accompanied the inauguration of the lend spend program the years intervening have caused men to grow less sanguine of its results Borrowing on an extensive scale has occurred men have been given employment and an expansion in private business activity has resulted nevertheless, pump priming' has not worked in the manner originally anticipated The initial premise that as recovery appeared private business activity would continue to expand on its own, permitting the government to withdraw its support has not been realized It has become increasingly more evident that unless government spending is supported by private anticipatory investments the program is doomed eventually to fail

Many treatises have been written explaining why private investments have failed to be made in the necessary amounts One group of expositors holds to the thesis that the government program was ill conceived and confusingly administered that punitive tax legislation, confiscatory tax rates ill advised labor legislation inflation inducing borrowing have all contributed to the creation of a psychology of pessimism [11] It is too much claim they to expect risk capital to venture out into so uncertain an atmosphere an administration more sympathetic to, and understanding of the problems of business is needed to dispel the gloom

There are those however who find little, if any consolation in the 'restore confidence and all will be well theory The easy confidence of those who claim that if the present depression is but given its head it will run its course in due time is not shared by this group The crash of 29, in their opinion, did more than announce the advent of a depression it sounded the knell of an era, an era in which man dotted a new continent with farms and cities and bound tightly together its farflung parts with bands of steel an era that witnessed the inundation of the handicraft system by the onrushing tide of the new industrialism with its marvels of mechanization an era in which a fertile land encouraged an ever west ward moving people to multiply their numbers All this they believe lies behind now out where the blue begins, secular stagnation stalks across the horizon

[11] See Third Fortune Forum of Executive Opinion in *Fortune* Dec 1940 pp 103 ff

In retrospect the nineteenth century becomes a period of seemingly limitless investment opportunities Business though stopping at times to catch its breath pushed onward avidly seeking out those who were willing to have their savings transmuted through the alchemy of industry into capital goods Thrift was not only a virtue in itself and hence to be encouraged but what was of more immediate importance it created the very clay from which the sought for capital goods could be molded The flow of savings into investments was assumed to be automatic the rate volume and direction of the movement being controlled by an impersonal interest rate As long therefore as the rate of profits remained high investments were made and savings found ready employment All was well and man could look forward to tomorrow with confidence and hope

Those who view the future with misgiving suspect that much of what currently passes for analysis is but nostalgia a nostalgia which in nourishing itself on the past has grown blind to the changing world in which it dwells A society which bases its reasoning upon analogies drawn from the experiences of the nineteenth century is courting disaster and disillusionment They point to the disappearance of the physical frontier the decrease in the rate of population growth the increasing rigidity of the price mechanism and the spread of economic nationalism as new factors which give to the discernible future a character distinctly its own The investment opportunities that arose with the opening up of new territories the construction of new cities the establishment of farms and the transcontinental rail and road systems that this expansion made necessary can no longer be looked to as outlets for savings Investment outlets in the future will if they are to be of strategic magnitude have to be found in the more intensive cultivation of already discovered fields But if this is to eventuate a reduction in unit prices so that potential consumers can be turned into effective buyers must be achieved Yet the increasing stickiness of the price system makes it questionable whether this objective can be attained Nor will savings when times grow hard at home find as ready an escape across international boundaries for autarchy is stripping capital of its former habit of international citizenship Therefore according to their analysis and it should be remembered that their position is not universally accepted whether private business confronted by these changed conditions will be able alone to provide investment outlets of sufficient magnitude to protect society against chronic unemployment becomes highly problematical

Chronic underproduction can be avoided they believe if the government assumes the role of an investment banker The decrease in private investment activity would be compensated for by the state s borrowing the idle savings of the community and investing them in income expanding expenditures or self liquidating undertakings The government acting as an intermediary would assure the continued flow of savings into capital

creating activities and by that act maintain a high level of employment so it is claimed

Two questions may be raised Where are these investments to be made and why would they probably not be made by private industry? One field which suggests itself is the conservation and development of natural resources The Ohio the Mississippi and numerous other rivers called upon to do a task too great for the crease in the earth allotted to them have again and again wreaked their vengeance on the countryside through which they rush They are respecters of neither property nor life and the toll they levy is reckoned in both dollars and lives Though the Father of Rivers serves men by carrying his goods its muddy waters mark it a thief of man s soil To save the nation the gigantic sums which these rivers annually exact as tribute they must be made subject to man s control But f this is to be done it is not enough for some community to raise its levees nor for another to build a dam the problem is not local but regional in scope The project must be far reaching mountains must be reforested eroded areas must again support vegetation and carefully developed systems of dams and artificial lakes must be created A comprehensive scheme of flood control would enrich the country by preventing the continued dropping of millions of dollars in the river And too such projects offer investment opportunities of unlimited proportions to the government For the present at least there would seemingly be little conflict with private enterprise for it does not appear that this type of activity would be of direct interest to private business The returns in a business sense would be far too uncertain and far too distant to induce a private corporation to hazard its funds

Too there is the field of low cost housing It is questionable whether private industry particularly in the large metropolitan areas can anticipate an expanding demand for low cost construction as long as the building trades industry continues its notorious monopolistic and quasi monopolistic practices If acceptable housing is to be available to the multitude of low income receivers there must be a reduction in the cost of construction If a more rational attitude toward cost price relationships cannot be evolved if each element in the industry continues in its stubborn refusal to make concessions private industry cannot possibly meet this need If this field is to offer employment to vast amounts of capital the existing log jam must be broken And if as it seems private industry immobilized in a strait jacket of rigid prices cannot move to free the logs the task falls to the government The state if it cannot through the inducement of large contracts secure price concessions from those who comprise the building industry can by direct or indirect subsidies to those who are to dwell in the houses offset the high costs of construction

It is therefore believed by some that unless the government compensates for the decline in private investment by expanding its own borrowing

and investing the economy faces a period of widespread unemployment shrinking national income and destructive socio political disturbances

Government Borrowing and Inflation

The term inflation has been so freely bandied about that it has come unfortunately to mean almost anything that the user finds necessary to fit his purpose The result has been to make the word a most illusive term it too often in current polemics becomes as uncertain to handle as an eel In order that some greater degree of accuracy may obtain the term inflation when herein used will refer not to changes in particular prices which must occur constantly if the price system is to function but rather to those increases in prices which are general throughout the entire price structure increases which do not occasion a commensurate expansion in the physical volume of production

If government bonds are purchased as long term investments by individuals out of their real savings inflation does not result In order to make his purchase the buyer would be compelled to decrease his consumption expenditures by an amount equal to the price of the bond This type of sale involves a transfer of purchasing power from the purchaser of the bond to the government Although the direction of demand would in all probability be changed the total volume of monetary expenditures would not be affected This would hold as long as the purchaser did not use his bonds as collateral to replenish his funds through a loan at his bank But the percentage of bonds sold to investors who intend holding them constitutes but a fraction of the total volume of government securities sold The bulk of purchases is made by financial institutions particularly commercial banks

If a commercial bank should purchase government bonds out of it idle funds, the immediate result would be a change in the composition of its assets The bank's cash or excess reserves would be diminished while its investment in government securities would be increased In short the bank has availed itself of an opportunity to put to work funds that were lying inactive it has accommodated the government in much the same fashion as it would any other borrower If the government were to leave the funds thus obtained as a deposit in the bank making the bond purchase it would be mandatory upon that bank to maintain a reserve against the new deposit If the government should elect to deposit its funds with its fiscal agent—the Federal Reserve Bank—the member bank making the loan would have its reserves at the central bank decreased by the amount of the government deposit The bank would have paid the government by a check drawn against itself which when deposited at the Federal Reserve Bank would have been debited against the bank s account maintained there What most probably would happen is that the government soon after securing the loan would draw checks against this loan

deposit in order that its creditors could be satisfied If this were done the money while not necessarily returning to the identical bank which made the loan in the first instance would flow back into the banking system as a private deposit and as such would require just as the government deposit did reserve backing Whether such government borrowing will in the end prove to be inflationary depends upon the use to which the bank puts the government bonds which it now carries in its portfolio and this decision will not be determined by the bank alone but by the state of private business as well

If private business spurred on by the prospects of greatly enhanced profits should extend its investment activities the banking system would be called upon to provide new credit accommodations The banks could accede to these requests as long as their reserves adequately covered the newly created loan deposits When the bank impinging on its reserves, could no longer meet the demands of business it would be forced either to curtail its lending or, if it were reluctant to do this to replenish its reserves by rediscounting or borrowing from its reserve bank This process could be continued provided that the bank s holdings of government bonds were sufficient until the reserves of the central bank in turn were depleted And if the government should be borrowing at the same time as business is it is not probable that the Governors of the Federal Reserve system would in the face of government opposition endeavor to check the expansion of credit If this swelling of credit goes on unimpeded so abundant are the ultimate reserves of the central system that a general upswing in prices would be inevitable Once this expansion has got under way the forces making for its continuance tend to be self reenforcing The upward spiral of prices continues until the whole structure crumbles under its own artificially inflated weight

There are those however, who are convinced that the tendency to over emphasize the importance of the banking factor in this problem of inflation has obscured other, and possibly more important, factors That the commercial banking system is full to bursting with government securities cannot be denied but that fact of itself does not make inflation inevitable A deep reservoir of credit is still a reservoir which will not be drained until the taps are opened and it is the hand of business which turns these taps but only when it is profitable to do so If it be assumed that this flow of credit should start there are some 8 million unemployed extensive unused resources and vast quantities of idle plant capacity which would first have to be absorbed in the productive process before scarcity conditions could prevail Any upswing in general prices would call back into use these factors of production and as they were utilized the goods and services which their employment would bring into being would tend to check a continued rise in the price system

If those who anticipate a period of business stagnation are correct in

their analysis then inflation should be a much less feared possibility than chronic unemployment If an era of decreasing private investments is the lot of the future it would hardly seem fitting to expect banks to be called upon to stretch greatly their credit facilities The great danger according to them is that the fear of inflation may so hamper government borrowing that the situation rather than improving may go from bad to worse until eventually the people swayed by a panic psychology may turn as a last resort to the printing presses and thus drive the country unwittingly into the very evil it has wished to avoid—inflation

However there is one possible event which if it should occur may prove the very catalytic agent necessary to start the reaction that event is war Businesses especially those classed as war industries would be aroused from their lethargy and abandoning their pedestrian pace would start forward at a brisk stride finally breaking into a headlong run Increased production expanded plant capacity and additional credit facilities would become the order of the day Once again business would comb the market for employees and materials The volume of unemployed would further be reduced to supply the demands of an expanding army And if the last war offers any indication of what is to come one event which appears most likely is that credit will be called for in staggering amounts both by private industry and the government With the government competing with business for funds the credit resources of the country would be used to the utmost and any attempt to prevent a continuous expansion of credit would be swept aside in the name of war needs As the war progresses resources would grow less and less abundant until eventually scarcity would rear its head Finally this scarcity of resources combined with a continued expansion of credit would cause prices to rise but as they rose they would fail to call forth a commensurate increase in the physical volume of production Inflation would then be inescapable as a result of these conditions

Are Government Debts Passed on to Future Generations?

One criticism frequently advanced against long term government borrowing is that it saddles a heavy burden on the backs of generations yet to come It is interesting to note the difference in attitude of the man on the street toward public and private debt For the most part he is convinced albeit in a somewhat vague way that a public debt creates a burden which will weigh down his children and his grandchildren Yet he at the same time will not be at all disturbed at an expansion in business debt In fact he may greet an active bond market with enthusiasm for to him it is a sign of prosperity His reaction may in part be attributed to a pattern of thought that makes him think of business debt as a normal accepted practice while public debt he senses as bad housekeeping To return to the matter at hand however the subsequent discussion will

distinguish domestically held from foreign held public debts and then treat of the objective burdens of public debts

If a government debt is held internally that is within the country the servicing of that debt does not decrease the volume of privately controlled purchasing power In order that the interest and amortization charges can be met the sums must be raised in taxation But the amount so raised is returned to the people when the government services its debt Hence the people of that nation as a whole have not experienced any decrease in the total amount of *privately* controlled purchasing power That which was taken from them as taxes has been returned as interest If future generations continue to pay additional taxes to meet the charges on this public debt the bonds must still be outstanding and if this be so they must be held by someone Therefore while future generations pay they pay via the government themselves The future generations then do not surrender any of their purchasing power that part of their incomes which is taken as taxes is returned as income

To stop at this point however would leave the picture unfinished Tax payers constitute a far more numerous group than do bondholders Too many bondholders, because of the tax exempt privilege pay a smaller sum in taxes than their money income would seem to indicate that they should Even though society as a whole experiences no decrease in the total amount of privately controlled purchasing power some members yield up part of their income to other members And to the extent that this transfer takes place some people have less and others more with which to satisfy their wants

The weight of the burden would be minimized if the taxes paid by each individual equaled the interest he received on his government securities To achieve such a distribution of taxes however would require a tax structure that bore some relationship to each individual s holdings of government bonds Any attempt to work out an exact relationship for each individual does not appear to be administratively feasible However, it is conceivable that some broad approximation could be achieved The probabilities favor the assumption that the wealthier members of society are more likely to be bondholders than the less fortunate members If this assumption be correct then a progressive tax system would approximate more closely the society as a whole result than a tax system which relied chiefly upon consumption excises In conclusion a public debt passed on to future generations if internally held does not decrease the total amount of privately controlled purchasing power it will in all probability cause a redistribution of that purchasing power however And if the burden incident to this latter redistribution is to be minimized then, a progressive tax system is necessary

If the bonds should be held externally a burden falls upon the debtor nation No longer do the interest and amortization charges constitute a

transfer of purchasing power within the issuing nation Now part of its national income must be diverted abroad so that the claims of the creditor nation can be honored Thus if American bonds were sold say in London the English purchasers would expect their payments to be made in pounds sterling The American government in order that it could meet these obligations would have to build up credits in London To do this she would either have to export gold or if this were not feasible owing either to economic political or military reasons she would have to maintain a favorable trade balance The excess of American exports over imports could be paid for by deposits in favor of the American government in London Thus funds would be made available to the American government to meet the interest and amortization charges on that part of its debt held in England This would mean unless increased labor expanded the national income sufficiently to compensate for the loss that the American standard of living would be lowered by the amount of the exports required to service the foreign held debt In short part of the productive efforts of Americans would be going not to satisfy their wants but to expand the income of Englishmen

But even though it be granted that a nation which borrows from itself does not cause future generations any loss in purchasing power doesn t the expenditure of the borrowed funds diminish its inheritance? The issue is raised particularly as it relates to war expenditures The physical goods with which the war generation fights the battle cannot come from the labors of those still to come any more than the armies can be recruited from the ranks of men yet to be born Armies are sustained from the existing supply of foodstuffs and armaments are created by diverting existing labor and resources from peace time to war time pursuits The objective cost which falls upon the war generation is the decline in the volume of consumer s goods which this shifting of resources entails

There is one manner however in which future generations can be called upon to bear part of this objective cost As peace time industries become less and less essential to the immediate problem of winning the war they fall in disrepair Since depreciation and obsolescence are not provided for generations to come are left with less efficient peace time productive equipment Their patrimony has to this extent been reduced

Should Government Debts Be Retired?

Are there reasons why a government should strive whenever the opportunity presents itself to retire part of its debt? The answer sometimes advanced is that such attempts are pointless It is claimed that they merely reflect the what is good for the individual is good for the government theory Or it may be held that since other nations carried huge debts there is no reason to assume that the American government is less capable of this feat than they A closer inspection of these reasons may

show them for what they are usually nothing more than offhand opinions arrived at in a rather rough and ready fashion The answer to the question originally posed if it is to be meaningful demands something more than this The analysis must be related to the cost of the debt and to the purposes for which the debt was incurred

The cost to society of a debt depends upon the relationship which the interest charges bear to the national income The higher the percentage of the national income taken as taxes for the purpose of servicing the debt the greater is the burden It could be held, therefore that if the wealth and income of a nation should increase at a more rapid pace than its public debt the burden imposed by that debt would be reduced Hence it is argued that by permitting the debt to continue undiminished the expansion in the national income which it is assumed must take place will automatically reduce the burden imposed by the debt But what if the national income should fail to expand what if it were actually to decline? These are not unknown phenomena nations and communities have had such experiences If this were to occur the failure to retire the debt in the days of greater affluence would mean an enhanced burden The objection may be raised that it matters not for after all the income taken from the people as taxes is returned to them as interest However the greater the sum which must be raised through taxation the more difficult becomes the administrative problem every weakness in the structure is accentuated every injustice becomes more pronounced Furthermore since interest charges are a recurring expenditure, the people in the face of a decreasing national income and always more conscious of the taxes they pay than the services they receive, may hesitate to approve other and perhaps greatly needed expenditures lest their taxes become too great for them to bear Therefore, it may be more prudent to take advantage of the opportunities which more opulent times offer and reduce part of the debt than chance the retrenchment program which a period of falling income may usher in

If government bonds are not retired the country is saddled with large fixed interest charges the dead hand of the past may tighten the purse strings and prevent the making of outlays in amounts adequate to meet some new emergency successfully The government is in a far more favorable credit position if it can face a depression or a war free from the encumbrance of past obligations To perpetuate past interest charges by refusal to wipe out past emergency debts is creating a formidable burden which when new interest charges are superimposed is apt so to weigh down the tax structure that it cracks under the strain

If the loan had been floated to finance a self liquidating project, the need to retire is less pressing The price charged for the service provides for the interest and amortization costs The taxpayer is thus not called upon to contribute to its support The same is true of debts incurred to

finance commercial projects assuming a price policy sufficient to cover all costs is instituted And finally funds borrowed to finance the creation of durable structures such as schools should be paid for during the life of the structure so that society will not be compelled to continue paying for them after they are no longer useful and must be replaced

In conclusion it may be stated that in light of existing conditions the question is not Shall the debt be repaid? but rather What *part* of the debt should be repaid? And the answer is not to be found in sweeping generalizations but only in those suggestions which are reached after a careful analysis of the composition of and purposes for which the debt has been made

PART VII

The Consumer

CHAPTER 25

CHANGES IN THE MARKET

Have you ever heard of a filling station that refuses to sell gasoline? There actually was such a station five years ago in Florida When drivers pulled up at the pumps the proprietor told them Not a drop today Maybe tomorrow I can spare two gallons And the drivers drove away—believe it or not—in a thankful frame of mind because of the half promise of gasoline tomorrow There were of course no advertising signs on the filling station and the owner made no effort to wipe windshields or be otherwise polite to customers Yet the customers kept coming back for more gasoline, and felt nothing but good will for the proprietor

The explanation of this strange condition lay in the fact that the station was located on the Florida Keys where all the gasoline was delivered in small boats There was therefore a perpetual shortage The filling station was enjoying a so called sellers market—a very rare occurrence in modern America If this illustration were offered to an American one hundred years ago he would not consider it at all unusual The merchant who tried not to sell his goods or who made no effort at all to attract customers was a fairly common figure Nor did customers resent such Spartan treatment They were grateful and rightly so to the storekeeper who succeeded in obtaining for them at irregular intervals some of the goods they wanted

Here we have one of the greatest changes in American history An economy of shortage has been gradually transformed into an economy of surplus The buyer one hundred years ago sought out and curried favor with the seller because there was a scarcity of the goods the seller had for sale Today the seller seeks out and curries favor with the buyer because there are more goods on hand than anybody wants to buy The change of course is distinctly relative There were some articles in the old times which were too numerous—patent medicines for instance—and the merchants of such articles pursued their customers and plied them with palaver In our day too there are some articles of which there is a shortage Antique furniture is an example The buyers of antiques pay court to the possessors of family heirlooms and use cajolery to make them part with their possessions It can be pointed out, also that any type of goods at any time may be plentiful or rare depending upon the price The price supposedly reflects the scarcity or the abundance of any given article But there are many situations where the price does not entirely correspond to the pressures of supply and of demand In such situations the buyer toadies to

the seller, if there is a shortage the seller toadies to the buyer, if there is a surplus After all due allowance has been made for exceptional and relative factors the truth remains that this country has been slowly passing from a seller s market to a buyer s market The significance of this great shift is revolutionary

The evidence that the shift has occurred lies all around us The word for it is sales pressure Whenever a customer enters any kind of store the clerks and the management treat him as a king His slightest wishes are accepted as law in the hope that he will buy at least a little something The customer is always right is the modern salesman s motto If the customers fail to come to the stores, the stores chase after the customers The chase is carried on by house to house canvassers, telephone calls personal letters and a dozen varieties of public advertising The modern citizen hardly manages to spend an hour of his day without encountering at least one request direct or indirect, that he spend his money to buy something He on the contrary, almost never thinks of having to urge someone to sell him something He takes it for granted that, if only he has the money he can get whatever he wants from a private yacht to an ice cream cone by simply saying so The problem of the consumer is like the problem of a girl with a dozen suitors—to avoid saying Yes too often

The forces underlying this universal sales pressure are worthy of analysis These forces divide easily into two groups—the motives of the producers who sell and the attitudes of the consumers who buy

The Motives of Producers

The most obvious force in the first group is mass production By modern machinery we make ten or one hundred times the quantity of things that the same labor formerly produced by hand Handmade nails to take one out of a thousand illustrations used to be scarce enough so that old buildings were burned down to get the nails Nail production by machinery is seventy times as fast and nails are now so plentiful that they litter streets and are a menace to automobile tires Everywhere—in industry in agriculture in mining in the circulation of ideas and in the pursuit of whales in the South Seas—the devices of mass production are piling up the goods in quantities heretofore unheard of This naturally means that customers are, so to speak, surfeited with products and the difficulty in persuading them to buy all of the goods becomes impressive Mass production creates almost by definition a buyer s market

Yet this is only the beginning of the story There is also the factor of production ahead of demand When a suit of clothes for instance, is made by hand the tailor never touches scissors to the cloth until he gets an order The tailor has already found his customer before he starts production A clothing factory, however makes a thousand suits in a batch, before a single order has come in When the suits are finished, the job of

finding customers begins A thousand men must be persuaded to like and want the particular type of cloth and style of tailoring that is already an accomplished fact This calls for persuasion by advertising and by sales manship Otherwise the thousand suits will probably be gathering dust on some merchant s shelves

Production in advance of demand is standard practice in most machine made lines There is no other way if the full economies of mass production are to be obtained From razor blades to breakfast foods the public has to be educated to accept an already finished product As Henry Ford is said to have remarked regarding the old Model T The customer can have any color he wants as long as it is black

A third feature of the situation is the national market The typical prod ucts of our day are made in just one town and sold in a thousand other towns hundreds of miles away There is no chance for personal contact between the maker and the user of a pair of shoes or a set of automobile tires The old fashioned handicraft producer had a local market He was personally acquainted with many of his customers Whatever sales pro motion he might do was woven in with all his other conversations with his neighbors almost unconsciously The gap between producer and con sumer under mass production can be bridged by no such casual means The problem calls for heavy outlays for display advertising or mail order catalogs or travelling ‘ drummers to tell the consumer all about the goods and how wonderful they are A great deal of our sales pressure is simply this attempt to talk to customers across a space of a thousand miles Such long distance talk has naturally enough the characteristics of a shout rather than of normal conversation

Perhaps the strongest force of all behind sales pressure is the item of overhead costs Overhead costs or fixed charges are the bugaboo of manu facturers They represent a bill which has to be paid whatever else hap pens Under overhead costs are included all the expenses of maintaining a plant and its equipment These expenses are approximately constant whether the plant runs at full capacity or stands completely idle It is the other type of expenses—so called variable costs—which change with the amount of manufacturing activity Variable costs are wages paid to labor and the bill for raw materials Workmen can be hired or fired and mate rials can be bought or not bought in direct proportion to the amount of production but overhead costs go right on piling up whether there is any production or not

The main point is that in mechanized manufacture overhead costs are high and variable costs are low Machines are introduced in order to save labor When laborers are laid off that cuts the variable costs But machines cannot be laid off they have to be maintained whether they work or not So every new machine adds to the overhead, at the same time that it reduces total payrolls

The whole matter can be clarified by an example An automobile maker has an overhead expense (plant and machinery) of $10 000 000 a year His variable costs (raw materials and labor) are $300 per car If he sells 50 000 cars at $500 each he will exactly meet his expenses

Expenses—Overhead costs		$10 000 000
	Variable costs for 50 000 cars at $300	15 000 000
		$25 000 000
Receipts—50,000 cars at $500		$25 000 000

This is what is known as the break even point ' If less than 50 000 cars are sold the concern loses money If there are more than 50 000 sales profits begin There is no way usually of getting around these figures The manufacturer absolutely must sell 50 000 cars Whether the public want the cars or not, they must be made to think they want them So the high pressure sales drive begins and keeps up until at least the 50 000 cars are sold

Moreover the automobile maker studies his figures closely and dis covers that his profits increase *more thar proportionately* with each addi tion to his sales above the 50 000 mark If he finds customers for 60 000 cars his profit is $2 000 000 If he sells 70 000 cars the profit is $4 000 000 (Figure this out on paper if you doubt it) By adding 16% to his sales he boosts his profits by 100% Here certainly is a place to put money into advertising Even a big sum for sales promotion will be well spent if it boosts sales by that extra 16%

The same principle appears as regards losses below the 50 000 car break even point With 40 000 sales the concern loses $2 000 000 With only 30 000 sales the loss is $4 000 000 A drop of 25% in sales adds 100% to the loss Here also is a place to pour in money for sales pressure Busi nesses tottering on the edge of bankruptcy will advisedly spend extra funds on advertising The money will not be wasted at all if it creates a few thousand extra sales and thereby more than proportionately, cuts the losses

This matter of overhead costs becomes even more pressing when we realize that it includes not merely costs of manufacture but also costs of marketing Mass production requires for its success a large market The market in many cases has to be nation wide, or even international in or der to procure sufficient sales This means that there are heavy expenses involved in transporting the goods over hundreds of miles from the fac tory to the consumer in maintaining warehouses at local distributing points and in the establishment of showrooms and demonstration agen cies in a thousand county seats Most of these costs are fixed charges The facilities exist and must be paid for whether sales are large or small Here again appears the drive to step up sales by almost any method, since the

sales organization has itself become so large and so unavoidably expensive

It may be pointed out of course that many manufacturers have nothing to do directly with the sales of their own products The manufacturers sell to wholesalers and the wholesalers sell to retailers The costs of marketing are thus met not by the manufacturer but by the so called middleman Yet the costs of marketing are still there and they are still largely fixed and inescapable It is the middlemen who under such arrangements exert themselves to step up sales by almost any method The wholesalers and retailers are the ones who hire more and more salesmen and print more and more advertising in their efforts to surmount their own overhead expenses

We should remember that, in contrast handmade goods had very little overhead The sales costs were small because the sales were made to neighbors The costs of building and maintaining a plant were small because there was no machinery The expenses were almost entirely for raw materials and labor varying directly with the amount of sales If an old time wagon maker sold no wagons for a month he could simply close shop and go fishing He would not be making any money but he would not be losing much either The incentive to go out and battle for a few extra customers was not particularly strong But the modern automobile maker has no restful berth Those overhead costs keep him fighting every month and every day to capture a few extra buyers somewhere in the country

There is finally at least a suspicion that some of the campaigns to increase sales are cases of conspicuous waste They belong in the same category with elaborate mansions fancy gardens retinues of servants and other means by which the rich display their wealth and their importance A wealthy manufacturer likes to show off commercially as well He may get no money income at all but he gets emotional satisfaction out of seeing his name blazoned on a dirigible floating above Miami or out of being able to show friends the swank offices of his foreign branch on the Champs Elysee There are said to be factory executives who choose their own advertising because they personally like it No amount of proof that the public does not like it will quell their impulse for conspicuous display Not every sales campaign produces sales or has sales as its main objective

Of course a vast amount of all the types of sales pressure could be cut out by one simple expedient That expedient would be a cut in prices If anybody wants to dispose of an extra supply of goods the quickest and surest way is to offer them at bargain rates If the bargain rates fail prices can be cut still lower The only limit is the cost of production Below that limit obviously the producer would be selling at a loss Reducing prices is the theoretical answer to any problem of surplus

But here again the manufacturer complains about his overhead costs If he offers his automobiles for $400 instead of $500 how can he guess the number of additional cars that will sell at the new price? Will the extra sales be enough to cover his $10 000 000 overhead? In our arbitrary example it would take 100 000 sales instead of 50 000 to reach the break even point Cutting prices means a big gamble which a conservative executive is very loath to take

Moreover he lives in mortal terror of his competitors If he cuts prices his competitors will follow suit They may even cut below him and so force him to cut still further The losses for everybody once a price war starts may be tremendous In California not long ago a price war pushed gasoline down to 5 cents a gallon All the competing companies were facing ruin Peace had to be made on the basis of a return to normal prices Until the Siamese twin specter of cut throat competition and overhead costs is somehow banished there seems little hope for general price reduction as a method of increasing sales Rather than take that sort of plunge most executives will try once more to dig up a few extra customers at present prices by some new ' special inducement or new variety of ballyhoo

Attitudes of Consumers

When business executives take a good look at the average consumers of the United States, their preference for ballyhoo is mightily confirmed The consumers with notable exceptions appear very much like sheep waiting to be shorn It seems a shame, so to speak to overlook their gullibility and merely sell them what they want when they ask for it

This gullibility of consumers is by no means a new circumstance The records indicate that purchasers at the old fashioned general stores accepted sand in their sugar alum in their baking powder and plain poisons in their patent medicines without much protest The wooden nutmegs of the Connecticut peddlers became proverbial How extensive these abuses were there is no means of knowing Chicanery in selling goods is certainly not an innovation of the twentieth century Yet it does seem probable that the opportunities for sharp practice have become more numerous in recent years The degree of the consumer s gullibility, in other words has definitely increased

The consumers, in the first place have lost a great share of their knowledge of goods This is the obvious result of the decline of production in the home People who have separated cream and churned their own butter know good butter when they see it A family that has carried the production of a suit of clothes from the wool off the backs of their own sheep through to the sewing of the finished garments is very likely to be hard to fool regarding woolen cloth This sort of critical intelligence based on direct experience was very common a hundred years ago Purchasers knew

furniture because they had worked with wood they judged pork on the basis of the pigs which they themselves had raised and butchered they went into a bakery with a long memory of pies and cakes and bread baked in their own kitchens Such knowledge dies out slowly Experience gained in childhood in an old fashioned homestead is still recalled and utilized fifty years later in a city apartment Parents hand on part of their experiences to the next generation and the son may have an eye for good apples and pure maple sugar because his father boiled sap and gathered russets

Ultimately however such knowledge dies Many modern city dwellers are two or three generations removed from the time when families made their own bread and butter and four or five generations away from the time when wool was spun and cloth was woven in the home What such people do not know is pitiful They buy their apples by the redness of the skins their eggs by the whiteness of the shells and their cheese by the fancy label on the package When they buy cloth they go through the time honored ritual of fingering the texture but they are nonetheless incapable of recognizing shoddy or noticing the looseness of the nap They prefer artificial flavorings because they never gathered peppermint or picked wintergreen berries and so on When the sons and daughters of the tenements and the apartments go shopping they are often just plain suckers and very tempting meat for enterprising salesmen

An increasing number too of the articles in stores are quite beyond the range of home gained personal experience The products of synthetic chemistry and the whole gamut of mechanical and electrical devices never could have been made by domestic processes and would baffle grandmother at least as thoroughly as they do us Whatever one may know first hand of woolen or cotton cloth will give no help in buying rayon or nylon An old hand at judging woods has to throw up his hands in the presence of plastic chairs and tables All the experience in the world with wagons helps very little in picking a good automobile Into the wonderland of electric razors percolators phonographs and air conditioning apparatus the consumer wanders unaided and unwary He buys the article that looks the prettiest or has been most often mentioned in the advertisements and goes home to repent at leisure He may struggle with his new gadget for years and still call it good because he has no standard of comparison What is the use from the manufacturer s viewpoint of even trying to turn out excellent products when the public has no idea, and no way of getting an idea of what an excellent product really is?

The situation has been further aggravated by the growing emphasis on stylishness and showiness To many men and most women especially in the large cities the maintenance of an attractive front is a primary necessity of life In the shifting contacts of a metropolis first impressions are of vital consequence In business dealings and in social circles, every

one must look his best if he wants to get ahead A smart car an impressive home and a trim attractive personal appearance are prerequisites for success

This state of mind makes the consumers themselves largely indifferent to the quality of many of the things they buy What they want are goods of the very latest fashion that make a brave display Such factors as usefulness or durability are of very secondary consequence If an article is honey combed with hidden defects that does not matter Before the hidden defects appear they will be buying something newer and more stylish in its place

The extreme example is of course the hats which women wear No woman it is safe to say ever bought a piece of millinery because it would protect her head or because she hopes that it will wear for several years In fact she hopes that the hat will not last longer than one season If it goes to pieces she will feel justified in buying a new piece of headgear duly decked with next season s striking gewgaws The same principle applies to women s shoes handbags bathing suits and every other article of feminine accoutrement

But the amazing thing is the extension of the principle of style and show to fields entirely removed from women s fashions Bathtubs and toilet seats are being stylized and bought for appearance s sake Furnaces are decked with parti colored enamel christened heatolators and purchased for their decorative value in the basement play room The enthusiasm for stream lined automobile bodies went so far that drivers had a good share of their visibility cut off and could not see where they were going The public apparently, had to have a car that looked like a dew drop no matter what mechanical hindrances might be involved

When the consumer puts so great an emphasis on looks impartial standards of quality become impossible Whether a mauve colored dish washer is better than a rose enameled one is entirely a matter of individual taste If the housewife becomes color minded to that extent neither she nor the manufacturer needs to care too much about the ability of the dish washer to wash dishes At that point, the door is wide open for sales pressure A newer and a prettier dish washer can be foisted on the family every year or two the manufacturer is getting his increased sales and the housewife is happy in the assurance that she is keeping up with the Jones

The final factor in explaining the consumers gullibility is the multitude of purchases As specialization increases each worker in the nation gets his money income from producing just one thing and with that money income he buys almost every other thing he needs A maker of false teeth for instance does nothing else but make false teeth He may make a set of false teeth for himself and if he does, they will undoubtedly be good ones But all the rest of his necessities he buys from other specialists and the list of those necessities is so long and so various that he simply has

no time or energy to inquire into them He takes his earnings at the end of a tiring week and wanders downtown He comes back home with two pounds of bacon a screwdriver a pair of socks a bottle of shaving lotion three electric light bulbs and a quart of strawberry ice cream He has walked into six shops, told the clerks what he wanted and taken what they gave him If what they gave him is not what he wanted he is probably too tired and too busy to do anything about it Probably there are several more things he forgot to buy and he puts what thought he has to spare on them

Our grandparents had a much different attitude toward their purchases Store bought articles were rare in their scheme of life When they did decide to spend a little of their small supply of cash they made a job of it They visited several stores compared prices and inspected and discussed the rival wares They had, as compared with us plenty of time and not much money and they used their time to make their money go a long way Buying was often a sort of sporting event in which the game was to outsmart the storekeeper by getting a high value at a dirt cheap price Old fashioned consumers were much more difficult to fool in consequence than modern shoppers with their multitude of purchases and hastiness in purchasing

If there is any doubt remaining as to the woolly mindedness of present day consumers that doubt will be dispelled by a good look at the high price buyer This is the man or woman who in default of any other standard calmly assumes that a high price means high quality The more the stores charge such a customer the better he likes it Two department stores offer exactly the same article for sale at the same time One store sets the price at $1 00 the other at $2 00 The crowd of shoppers all pour over to the store with the $2 00 price and buy there Ribbons which have been on sale at 39 cents a yard for several weeks are to be marked down as a bargain at 19 cents But the clerk makes a mistake and the new sign reads 49 cents a yard Hurrah say the customers here s a real bargain as they rush to the ribbon counter The annals of merchandizing contain many instances of this sad sort Barnum s remark There is a sucker born every minute, would appear to be an understatement

The Consumer Movement

The great changes which have taken place in the attitudes of consumers and the opposing shifts in the producers point of view are making trouble in America The producers as we said are putting more and more sales pressure on consumers Consumers are beginning to wake up and realize their gullibility Against the increase in sales pressure they are offering increased sales resistance The lines are being formed for a new type of conflict There are prophets who predict that a struggle comparable to that between labor and capital is in the offing

The consumer movement as it is called is fairly recent Its beginnings can be found in the early 1900s when public opinion was aroused by scandalous conditions in the great meat packing plants and Congress passed the first Pure Food and Drug Act at the vigorous insistence of Dr Harvey Wiley The labor unions began to urge the public to purchase only goods which bore a union label on the assumption that conditions in a union shop were sanitary A national organization of women called the Consumers League undertook a similar campaign to eliminate sweat shop products from the department stores

This early enthusiasm died away in the World War and the post war confusion Not until the pinch of the depression years did the present consumer movement gain real headway As late as 1933 when the N R A was organized an attempt to add consumer representatives to the code authorities broke down because there were almost no representatives of consumers Consumers it had always been assumed were the same people as producers How could people organize to fight against themselves?

It is now becoming clear that the modern American is a double person As a producer of one line of goods he has one set of attitudes and interests As a consumer of all the other lines of goods his position is quite different This duality is even more obvious within a modern family The husband is primarily the producer who earns the income The wife is the consumer who spends the income The estimates indicate that about four fifths of the buying is done by women It is no accident, therefore, that the consumer movement is largely supported by housewives

We now have consumer organizations working on a dozen different fronts Some of them are active in politics striving to enact consumers legislation Others are making tests and ratings of articles in order to improve their buying knowledge Still others are conducting their own stores with interesting results

The manufacturers and wholesalers and retailers are showing grave concern over these new consumer protests Sales conferences and trade association meetings devote increasing time to the consumer movement and methods of combating it

It can be pointed out to be sure, that the whole battle is simply the price we pay for success—both as individuals and as a nation The readers of this book for instance are relatively wealthy So are the authors of this book College students and college professors usually belong to the upper third or quarter of the income receivers in the United States It is because we have the money that the producers and the salesmen pursue us They chase the top flight millionaires even more avidly The poor families with annual incomes of $1000 or less are comparatively free from the burden of sales pressure

The same point holds in a large sense for the nation as a whole It is primarily because this country has been so successful in producing goods

in such enormous quantities that the problem of disposing of those goods becomes acute Among the poorer backward peoples of the earth sales pressure is the least of their worries They are still struggling with a shortage not a surplus of supplies and nobody is badgering his neighbors to make them buy what they do not want

The problem of the consumer has been described as a sort of economic gout Gout is the result of course of being relatively rich But it is none theless a painful ailment which clamors for a remedy

CHAPTER 26

SALES PRESSURES

The study of any disease of the body politic involves description of its forms and symptoms This takes us into the multiform and fascinating subject of sales pressure

Sales methods and devices are now absorbing many of the best brains in the United States Marketing advertising and so called public relations are subjects for graduate study in the most famous universities The man who can invent a new kind of sales drive is the hero of the sales rooms the advertising agencies and the whole world of business and finance

Sales pressure has become a vast industry It employs at least three million people Its annual income is difficult to estimate but it probably exceeds ten billion dollars annually and is increasing What all this money is spent for and how is the question that confronts us

Salesmanship

One major item in the total is the sales expense of retail stores Retail stores have certain very useful functions for which the public pays They keep on hand a wide variety of goods available in small quantities until the customers happen to ask for them They may deliver the goods carry the customers charge accounts and furnish more or less expert advice in meeting customers needs All such services may be regarded as entirely separate from any effort at sales pressure But modern merchandising goes much farther It introduces several come hither features which give little or no benefit to the innocent public These begin with fancy store fronts elaborate neon signs and expensive display windows They end with the polished manners and shrewd psychology of a high priced salesman who takes $20 from the customer for a $15 overcoat when the customer was only looking for a pair of socks No student has as yet attempted carefully to separate these methods of 'massaging the consumer from the retail services which the consumer really needs and wants An hour s experience in any shopping district will however demonstrate that consumers are regarded rather frequently as fish A lot of money is expended on bait and on landing gear and the unwary consumer who gets caught has to pay the cost of his own capture in the form of higher prices

Another large expense in selling is the salaries of traveling men These

agents maintain contact between wholesalers or manufacturers and the local retail stores Almost every concern hires them often by the hundreds They furnish many of the hitch hikers best rides they keep many country hotels alive by their patronage A great deal of what they do is definitely useful They inform the retailer of changes in the line of goods they put through rush shipments and adjust complaints they may give many hints as to improvements in the art of retailing itself On the other hand the cigars and funny stories they broadcast have long been looked upon as dubious And their newer methods of compelling retailers to stock their goods by flooding a community with special sales displays and advertising are equally of doubtful value Certainly when college boys are hired to pass out free cigarettes in country clubs and gaily costumed girls distribute sample chewing gums on Main Street the public is entitled to inquire who pays the bill for all this suave seduction and why The traveling salesman like the retailer needs a sort of chemical analysis How much of what he does is good and useful, and how much is adulterated has never been examined carefully

Packages and Premiums

A second type of sales pressure which is gaining rapidly is packaging The retailers of the nineteenth century handled most of their goods in bulk They dealt out pickles from a pickle barrel crackers from a cracker barrel sugar from a sugar barrel and so on The customer asked for whatever quantity he wanted and the package was done up on the spot The method involved dangers of spoilage and of infection But it had also the great advantage that the customer could see and handle what he bought before he bought it

The modern retail store has lost most of its boxes bins and barrels The goods are all in shiny small containers What may or may not be inside of each container is a somewhat doubtful question The bottle or the can may be designed to give an appearance of great size but it may be only three quarters full Containers offer a fine chance to fool the customers regarding quantity The quality of the contents is equally dubious The label invariably assures the customer that he is buying something that is extra super fine But there is no way of knowing in advance to what extent the label lies The goods may be extra super fine all right and yet not suit the customer s tastes or needs Two cans or bottles may be identically marked and yet may differ sadly when the customer has opened them The idea, from the producer s point of view would seem to be that the customer should simply put his faith in labels and accept the consequences

The label and the package also are expected to act as salesmen in their own behalf Producers deck out their containers with pretty pictures and bright colors, and see to it that each package carries its appealing mes

sage to buy oftener and buy more The package may be so attractive that its appeal is greater than the goods themselves A perfume bottle strangely shaped and called La nuit d amour will sell no matter what the perfume smells like Boxes of breakfast food are bought because the kiddies enjoy cutting out the cardboard figures on the box

Labels have ceased to carry mere information Packages have heavier duties than protection against dust and decay They have become part of the great campaign to capture more of the public s dollars by adding wheedling and deception to the useful merchandise

Along with the packages goes a procession of special inducements which have even less relationship to the goods themselves The package may itself contain a prize —a showy bit of crockery or a picture of a movie queen Or the labels if saved up entitle the purchaser to a choice of premiums —a pocket knife, or a colored landscape or even a bicycle Some sort of international guessing contest may be staged with big cash prizes the guessers being eligible only upon submitting evidence that they have bought one hundred units of the product The permutations and combinations of the special inducement idea are limitless But when ever such devices are employed there is a tacit admission that sales can not be made—or made in sufficient quantities—upon the merits of the goods themselves

Replacement

There are two objectives in sales campaigns of any sort One aim is to catch new customers the other aim is to make the old customers buy more This second aim is frequently accomplished by doing things to the product itself

The durability of the product may be decreased If it wears out faster the consumer will come back oftener for a new article A certain manufac turer of high grade hosiery was losing money and called in a sales expert The expert told him that his stockings wore too well So he put less quality into the toes and heels and turned out stockings that were guar anteed to wear out in four washings His sales mounted Moreover the new inferior stockings cost less to produce He both increased his income and decreased his expense by cheapening quality

Statements are made on fairly good authority that an automobile could be produced at slightly higher cost that would run 200 000 or 300 000 miles But what, if that were done would happen to the car market two or three years from now? The folks would still be driving their old cars with no bills for repairs and would be under no necessity of buying a new model There are examples of old fashioned sheets and pillowcases that were so well woven that they are still intact after forty years of use A modern mill could not afford to put that amount of quality into its products What we have in many fields is a good enough philosophy

that reduces durability to a point just short of where the customer s pa tience gives out before the goods themselves give out Rapid obsolescence as the phrase goes boosts sales

In other types of product quantities can be reduced A customer who buys a pound sized package that contains only 13 ounces of spaghetti will come back sooner for another pound of spaghetti Or the package may be loaded full but its size and shape may be so changed that it looks as if it held a pound but actually has room for only 13 ounces The great enthusiasm for packaging itself gives opportunity for several short weight tricks and every one of them increases the sales volume and at the same time cuts production costs

Styles have great possibilities in this connection The idea of style itself and of style changes cannot be blamed upon the manufacturers The public has probably a natural appetite for change at intervals in what it buys But the manufacturers can step up the style changes They can make the difference between this year s car and last year s car so obvious that owners rush for the new models in order to be up to date The tailors recently achieved a triumph when they introduced white evening clothes for men in summer time The well dressed young man now must have two dinner jackets in his wardrobe The headlong race of styles in women s shoes has been so successful that well to do women not only buy two or three times as many pairs as they wear out but the manufacturers them selves have been caught with large lots of shoes still unsold and already outmoded If styles in rings necklaces and silverware were not continu ally upset there might be no replacement business at all in so durable a line as jewelry

Just what would be a reasonable standard for changes in style or for quantity or durability at a given price is beyond any individual consum er s power of judgment But the consumer does know that many produc ers are trying to alter the existing standards with the aim of boosting their replacement market

Sales on Credit

One of the greatest weapons for overcoming the sales resistance of the public is installment selling The purchaser is told that he can have the article right now but he does not have to pay until later This is a strong temptation for many customers

Installment selling applies of course to large priced durable products It began with pianos and furniture fifty years ago and has spread to jewelry, automobiles washing machines radios and a variety of electrical devices The purchaser makes a down payment and a promise of regular monthly payments thereafter The car or whatever it is remains the property of the manufacturer until the final payment The payments are so graduated that the car is worth more in the second hand market than

the total of the remaining payments Consequently if the purchaser fails to meet one of his installments the manufacturer can promptly repossess the car and sell it to someone else without taking any loss A $500 car on which $200 has been paid can be seized and sold at second hand for $300 or perhaps a little more The original purchaser loses his $200 but he has had the use of the automobile in the meantime Buying on install ments turns out to be a quite expensive form of renting if the installments are not paid on time The purchaser moreover has to carry full insur ance on the car from the beginning and has to pay full interest on the purchase price until the end The interest may give the appearance of 6% on $500 but after all of the installments have been paid except the last one and the purchaser s remaining debt is only $50 he is still paying interest on the whole $500 What seems to be 6% interest really amounts to about 12% under these conditions Anyone with reasonable ability in arithmetic can figure out that it is definitely cheaper to pay cash for any article rather than buy on an installment plan

The installment plan has a variant that is even more expensive This is the personal loan It may be used to buy almost anything A customer who has no money at all goes or is sent, to a Morris Plan Bank or its equivalent There he borrows perhaps $100, giving his promissory note as security with an endorsement by some friend The interest he pays on such a loan is limited by law in many states to 3% a month This amounts to 36% a year of course The interest rate may be even higher if the loan is made by an illegal loan shark The loan shark will lend the $100 but demands a note for $150 The extra $50, which is not loaned but must be repaid amounts to an additional interest payment Such under handed arrangements are very difficult to detect especially when the poor borrower is ignorant of the law The interest and the installments on the principal have to be paid promptly, whatever the arrangement If the borrower delays his payments the sheriff can seize his household goods or any other property he has If the borrower s property is not enough, the property of the endorser is taken to make up the balance

No reputable manufacturer of course has any direct connection with the small loan business But the manufacturer s agents or the retailer who handles the manufacturer s products may encourage or at least not discourage small loans to cover sales After all the customer is too poor to pay cash and too poor to make the down payment under an install ment plan Without a small loan the customer will be lost, and customers are too precious to be lost

The whole idea of making sales by any type of credit is simply and solely a device for increasing total sales The results in many instances are bad for the consumer He gets stuck with an article he cannot pay for and ultimately has to lose or he scrimps on groceries or clothing to pay for something that he actually cannot afford These social conse

quences are overlooked by the high pressure sales departments who have to keep receipts at the break even point somehow and consequently try to pile up customers by any method that comes within the law

Sales Surveys

The hunt for customers has grown so keen that it is carried into the homes of the customers themselves by sales surveys These surveys make no attempt to sell the actual goods by old time door to door canvassing What they try to do is to find out who the people in a given district are what they like and dislike and how much money they have to spend A sample area is chosen and investigators sent to every residence with a set of leading questions How many children have you? What kind of music do the children like? Do you plan to send them to college? and so on The investigator notes the appearances of wealth or poverty in the home the type of furniture the periodicals on the table the dialect of the conversation and so on The conclusion may be that here is an area of fairly prosperous family groups who would be push overs for a line of classical phonograph records as part of their children s cultural improvement Or that the district has a crowd of adolescent youngsters who want to play in jazz bands when they get to college but have not yet been able to buy instruments The local music stores are stocked according to the findings plans for purchase on installments are publicized and advertising with the right type of appeal is circulated

The same data may be used by a breakfast food concern and by a corset manufacturer Once the complete analysis of the inhabitants of a town is made by scientific methods a dozen different sales promoters can move in on the customers with ease and certainty The procedure is so reliable that it is now in use for political purposes as well The well known Gallup polls are a by product of a technique developed in sales surveying and later extended to test public opinion on political matters

Another method of reaching similar results is the customer questionnaire A great motor corporation gets out a breezy pamphlet calling for a vote by all its users on each of several arrangements of headlights windshields and upholstery The customer feels flattered and enjoys airing his opinions On the basis of ten thousand replies the company can make a good guess as to what the public wants in next year s model, or how to make the public think that it is getting what it wants The same kind of customer reactions can in other cases be gathered through the retail stores

Sales surveys of either sort have definite utility to the public as well as to producers When a sales campaign begins by actually finding out what customers desire the customers can certainly have no objection Only when the data are used as a basis for bamboozling the public do sales surveys become objectionable

Advertising

The grandest of all avenues for reaching the consumer is the great art of advertising Almost every kind of goods or service designed for any type of customer is advertised Only the strictly organized professions such as medicine and law refrain from blazoning forth their wares in some variety of advertising medium

The technique of choosing the right medium at the right time with the right type of copy that will catch attention and will clinch a sale has become a vast business by itself There are half a million people in the country who devote their time to studying the buying power of the subscribers to particular periodicals the advantages of outside over inside full page covers the attractiveness of a particular font of type the color appeal of light blue as compared with orange and a thousand other details involving not only printed matter but billboards radio and even sky writing as well The experts in the advertising agencies stand ready to find a market for the newest or the most time worn commodity by a supposedly fool proof or scientific campaign

Advertising has grown so large that other businesses depend upon it The ordinary newspaper relies on advertising for two thirds of its revenue The newspaper struggles therefore to obtain not merely a large circulation but a large circulation among wealthy readers If the newspaper can show the advertising agencies that its subscribers have a lot of purchasing power that means more advertising at distinctly higher rates This is the subtle pressure that makes successful newspapers conservative in general policy—in order to attract the rich in order to attract the advertisers Similar influences play upon the weekly and monthly periodicals At the same time both the publishers and advertisers are subsidized by the United States Post Office Second class mail (newspapers and periodicals) requires only one sixth as much postage as first class mail This means that publishers can load their issues with high priced advertising and have the extra weight delivered at almost no additional expense

Radio of course is totally dependent upon advertising revenue There is therefore even greater pressure by the sponsors for the kind of programs which the people who have money will approve The advertisers pay high prices for the privilege of sponsoring a program that reaches buyers in well to do homes They are not so interested in radical news commentators or in hot jazz bands because the listeners to such performances are people with less purchasing power

The makers of book matches depend entirely on advertising for existence So do the producers of calendars and blotters and a wide variety of novelties The artist who draws comic strips or animated cartoons hopes to hire out his characters to the advertisers as a final reward Amateurs in a half dozen sports pay their expenses and more by endorsing cigarets

they seldom smoke or cereals they seldom eat in advertisements Even the former Queen of Roumania made a good thing out of a visit to the United States by selling her approvals to the advertisers

The phase of advertising however which interests consumers is its usefulness in buying This is a hotly argued question It can be partly clarified by dividing advertising rather arbitrarily into five classes

Informative advertising comes first This approximates news It tells the public something which was not known before The columns of want ads come under this heading So do the full page spreads of the department stores with their details regarding fabrics and prices for the shoppers guidance The massive catalogs of the mail order houses are highly informative They tell the farm wife a great many facts which help to meet her needs All of the advertising in technical journals is strictly informational Surgeons buying instruments or lawyers subscribing for a set of court reports expect precise data and they are given it If all advertising were definitely informative there would be no quarrel at all about its usefulness

The second type of advertising is alas much more familiar It relies primarily upon some sort of emotional appeal The various emotional appeals are carefully classified by experts The desire for health is probably the strongest A great campaign for the selling of whiskey had this as its basis Old people were persuaded—by means of the whiskey—to testify that it was the whiskey which gave them long lives The love of children is a powerful appeal It has been used recently to push the sale of a particular toilet paper The longing to make a good impression in society offers a good leverage Bashful people have bought Dr Eliot s five foot shelf of books in the vain hope that all that reading would produce cascades of brilliant conversation Love and beauty parade continually of course through advertising pages to help the sale of corsets and cathartics and a multitude of products

The standard emotional advertisement contains four features First an attention device—something which acts as a red light to make the reader stop and look Next the emotional appeal which is to soften the reader and make him eager and receptive Then the argument containing statements which sound reasonable and lead straight to the conviction This is a mighty good article after all ' And finally the action stimulus This is to get the reader on his feet and on his way to buy the goods before the effects of the advertisement die off Fill out this coupon immediately or Phone your druggist right away is the last sentence on the page

There seems to be just one excuse for using this emotional bait to catch the customers The excuse is summed up in the slogan It s great to be fooled There are sections of the American public who apparently enjoy being hooked occasionally or who seem to think of the whole business as a battle of wits where only suckers are the victims It seems obvious at

any rate that advertising which appeals to the emotions is only distantly related to the actual needs of customers There is a growing disposition to write down such commercial propaganda as just plain waste

On the other hand, an emotional advertisement may also include real information The news of a new device, or of a new improvement on an old device may reach the public only by this type of advertising The an nouncement that a better razor has been invented or that an improved device for shifting automobile gears is now available is of real interest to consumers The announcement may be surrounded by a welter of sensa tional devices but it is nonetheless informative The line of demarcation between emotional and informative advertising is in such instances ex tremely difficult to draw

The third type of advertising is closely associated with the second It relies for its results upon sheer repetition The name of the concern or of the product will be repeated and repeated until every citizen who can read has memorized the name involuntarily Or a catchy slogan will be devised and repeated endlessly The success of this device can be tested in any group Almost every American can repeat without any effort a dozen of the outstanding watchwords for cigarets and soap and automo biles and can tell you which brand name goes with each slogan In a few cases the final triumph of repetitive advertising is achieved when the trade mark name becomes the common name for the article itself The terms victrola instead of phonograph and B V D instead of under wear, are familiar examples

The object of this method is of course the establishment of a habit or involuntary reaction Whenever the customer thinks of buying, he automatically thinks of one brand only and purchases that brand The ad vantage to the advertiser is obvious By repetition he takes his product out of competition No other product may be even thought of in connection with his own The advantage to the consumer however, is very difficult to find He has been subjected to a sort of hypnotism which he may ultimately resent

Our fourth category is institutional or good will advertising Here there is no immediate attempt to sell The idea is to fix the name of the concern or product in the consumer s memory and to surround the name with con notations of excellence reliability and pleasantness Later on when the consumer has to buy, he will turn to the remembered name without a moment's hesitation

Institutional advertising is used extensively by banks and insurance companies by funeral parlors and cemeteries by railways and summer resorts Chambers of commerce use it to attract new industries state and national governments spend money on it to increase their tourist trade The method, in the form of oft repeated slogans helps push the sales of ordinary commercial products Such catch phrases as Say It

With Flowers or Ask The Man Who Owns One have been worth a fortune in consumers good will

No one knows whether institutional advertising pays the advertiser It is seed sown to the winds If it happens to take root in the right people s minds it may bear fruit a thousand fold or it may fall entirely on barren ground The first two types of advertising can be checked The number of replies is known or the increased volume of sales is measured fairly accurately But good will advertising is by definition a long term affair Its returns if any become unrecognizable in the passage of the years

This lack of any precise method of measuring results does not bother businesses as much as one would think it should The reason lies in certain financial regulations of the government A corporation may for instance be subject to an excess profits tax of 30 per cent If the excess profits total $100 000 the government takes $30 000 The executives of the corporation put their heads together and decide to spend the whole sum of $100 000 on advertising and so have no excess profits whatever As the executives see the situation they are getting $100 000 worth of advertising at a cost of only $70 000 Or take a public utility corporation which is subject to regulation by commission The commission under the law fixes the corporation s rates at a point which will give a fair profit after all expenses have been paid The commission does not regulate the corporation s expenses Whatever expenses are incurred in other words are added on to the rates The higher the expenses, the more the consumer has to pay The corporation s executives need have no worry as to how much they spend so they spend liberally—particularly on advertising The electric companies the telephone companies and the other utilities are conspicuous for their heavy campaigns of good will advertising Whether these campaigns produce results or not is no particular concern to the companies They pass the whole advertising expense on to their customers in the form of higher rates Thus quite unwittingly the government is urging corporations into splurges of advertising which otherwise would not be made

It is possible to describe a large part of institutional advertising as a form of unemployment relief or W P A It takes money that otherwise would not be spent and hires advertising men who otherwise would not be hired The projects in which the advertising men engage may or may not be of social value As in W P A , there is considerable ' boondoggling' in institutional advertising

The last of our five subdivisions is indirect advertising This is the work of the press agents and of the public relations counsels What they do is to spread what amounts to advertising in the form of news ' The public, when it sees the news is quite unconscious that it is subject to sales pressure This unconsciousness is the great advantage of the method

The devices of indirect advertising are ingenious The velvet manufac

turers are losing sales They call in their public relations counsel He arranges very quietly for new and dazzling velvet gowns to be worn by Hollywood favorites in their next pictures The descriptions of the gowns go out as news in the fashion columns the public sees the gowns in the picture and the sales of velvet rise A radio manufacturer has a new device for high fidelity reception which he is about to put on the market The public relations counsel starts a big discussion among music critics and music directors as to the miserable reception for orchestral music on the present radios The letters to the newspapers are full of complaints on the subject Then the radio manufacturer—in response to the public demand—comes forward with his high fidelity device and the sales break loose like popcorn in a hopper A conservative college which never advertises openly makes a point of sending a good half tone cut of each senior at commencement time to the senior s home town paper The picture is accompanied with a brief and glowing account of Henry s college record as leader of the chess team and winner of the volley ball tournament The prospective freshmen in each town see the picture read the story and have no suspicion that they are being sold by the particular college

These news releases nowadays pour into the newspapers from hundreds of different sources Many of the stories are furnished free in complete form all ready for the press Other stories are so cleverly planted that the newspapers have to pay for them or send out their reporters The editor is of course more likely to print a story that costs him something It has been estimated that a quarter or a third of the total columns in a newspaper is manufactured news Behind the account—his name and purpose cleverly concealed—is someone trying to sell something to the readers

Indirect advertising is obviously a form of propaganda It uses the same back stairs methods it has the same sort of definite design upon public opinion and it is often like propaganda in a rather complete fog as to the size and character of its results Those who accept propaganda as an honorable activity will approve of indirect advertising To others with a different code of ethics, both businesses are fundamentally dishonest

The reader might derive considerable fun and value out of checking the impact of each form of sales pressure on his own buying habits When has he been influenced by salesmen? When have packages or premiums persuaded him to buy? Was he ever talked into a purchase by an offer of easy credit? Which kinds of advertising get under his skin, and how? If this analysis is made with care, the result may be humiliating Most of us resemble puppets much more closely than we realize The sales experts pull the strings that pull our legs This thought may lead to a keen interest from a personal point of view in the devices for protecting all consumers from manipulation by the salesmen.

CHAPTER 27

PROTECTING THE CONSUMERS

Our forefathers had a Latin phrase to describe the basic situation of consumers— Caveat emptor or let the buyer beware Consumers were expected for the most part to look out for themselves If they were cheated or bamboozled in the market place it was their own fault and they could take the consequences

This was a fairly sound principle in a day when the barrage of sales pressure had hardly begun and consumers were much better armed for bargaining than they are now The present tendency is to regard the individual consumers as incapable of self protection The old maxim of caveat emptor is under fire and a new maxim— caveat mercator let the seller beware—is widely advocated

Common Law Remedies

Even in the old days however the buyer was not left entirely to his own devices The law gave him two definite and well established remedies—suits for fraud and for breach of warranty Both of these legal actions are parts of the English common law handed down from colonial times and still essentially in force

The definition of fraud involves two factors The buyer must have suffered definite loss as a result of his purchase and the seller must have had a definite intent to cheat the buyer If both these points are adequately proved by evidence in court the seller has to compensate the buyer for the full amount of damage done The seller is at the same time liable to criminal penalties Fraud is regarded by the law as a form of theft and thieves are required both to compensate the victims of their stealing, and to go to jail in expiation of their crimes

On first thought it seems curious that so little use is made of suits for fraud by injured customers But the customers have to obtain legal evidence of an intention to deceive and that is very hard to do A merchant who deliberately cheats a customer is very careful to avoid telling anybody of his underhanded methods When he is accused in court he claims that it was all a mere mistake and that it was no fault of his if the customer insisted upon buying an inferior product

The customer also has to face the question of expense Lawyers' fees and trial costs may run to hundreds of dollars in a simple suit for fraud

If he wins the suit these costs will be paid in large part by the defend ant But if he loses the suit he may have both his own and the de fendant s costs to meet In the average case where the damage itself amounts to only a few dollars the gamble on the costs of a trial is much too risky A man may have considerable evidence that he was sold a clock for $20 that was not worth a nickel but is he going to risk having to pay trial charges of $200 in the hope of getting back his $20? Suits for fraud are usually started only where the losses run into thousands of dollars and court costs are a comparatively negligible factor

Breach of warranty involves like difficulties It is a suit based upon a guaranty made by the seller as to the quality or performance of the goods A tire manufacturer may promise that his tires will last a year If the tires wear out in six months the purchaser has a legal claim for compensation from the manufacturer But the difficulty is that many guaranties have an escape clause The statement includes some such phrase as under normal conditions So the aggrieved purchaser has to prove in court that during the entire six months he was using his tires normally This kind of evidence is so tricky that a great many suits are never started

Warranty may be implied rather than explicit Even if the manufac turer makes no statement at all about the wearing quality of his tires the courts may hold that some degree of durability has been implied by the mere use of the term tires If the so called tires collapse at the end of the first hundred miles and there are no unusual circumstances in volved the court may award damages to the purchaser Implied warranty is however, a highly complicated legal concept No one should assume that it exists in a particular case without advice from an attorney

Here, again appears the problem of legal costs The little man stuck with the loss of thirty dollars on his tires may protest to the company If the company accepts his protest he gets another set of tires—perhaps no better than the others If the company rejects his complaint he will wisely obey the ancient maxim of the poor— keep out of the courts — and try to forget the matter Breach of warranty like fraud is a real protection for big purchasers only

These traditional remedies of the law have special meaning in connec tion with the attitudes of the courts The minds of many judges have been steeped in the doctrines of the common law They regard these doctrines as sacred and sufficient for all purposes When a new law for the protection of consumers is put upon the statute books these judges try to interpret that law as part of the doctrine of fraud or of breach of warranty If such interpretation is impossible they look for reasons for declaring the new law unconstitutional The layman often fails to realize the ways in which the legal mind of the judiciary balks or diverts his reforms

Punishing the Package

These concepts of the common law help to explain that peculiar method of protecting consumers—punishing the package This is the basic device of the federal Pure Food and Drug Act of 1906 and of its successor the Pure Food Drug and Cosmetic Act of 1938 It appears in many state laws also The desire is of course to prevent bad goods from reaching customers But if you undertook to punish the producers of bad goods you would have to require proof of fraudulent intent or else the courts would rejec the law as unconstitutional You could however seize the product itself rather than the producer and thus avoid legal pitfalls

The pure food and drug laws prohibit the sale of packages containing certain poisonous ingredients or of packages whose contents are misrepresented by the label The federal acts apply to goods in interstate commerce the state laws govern sales within one state The scope of these laws has steadily broadened so that they now cover most of the articles on sale in drug stores and in grocery stores

The major difficulty in this type of protection lies not in the requirements of the law but in the provisions for enforcement A large corps of inspectors is obviously required The amount of foods drugs and cosmetics moving through the trade channels is enormous The Pure Food and Drug division of the Department of Agriculture has never had the money to hire even a thousand inspectors for the whole United States The state enforcement bureaus are similarly undermanned The result is that the inspectors have to confine their efforts to a few peculiarly suspicious situations Many trainloads of cans and bottles go by them every day without being considered at all

When they do catch a consignment of poisonous or mislabeled goods they seize the goods and take the goods to court If they get a verdict in court they destroy the goods and the manufacturer has lost that many cartons or cases of his product The incident may cost the manufacturer $1 000 or more But in the meantime the manufacturer has marketed perhaps $100 000 worth of the same product without inspection His profits from adulteration on $100 000 worth of goods are more than ample to defray an occasional $1 000 loss through seizure

Quite possibly this loophole in the law could be plugged by wide publicity for every verdict If the public knew that fifty cases of a certain brand of soup had been confiscated by court authority the sales for that particular soup would drop But the newspapers refuse to regard such a decision as news The soup manufacturer or one of his business allies is a heavy advertiser The newspapers might lose some of their advertising income if they attacked business in this way

The pure food and drug laws often contain another type of legal

remedy The government can ask for a court injunction prohibiting the adulteration in the future of some particular product After an injunc tion is issued the violator is guilty of contempt of court and can be penalized at the judge s discretion Here again the doctrine of fraud makes its appearance The judges usually want evidence that the adul teration was deliberate and intentional before they grant the injunction They have gone so far in certain cases as to excuse a patent medicine manufacturer on the ground that he was not a physician and therefore could not know the medicinal dangers of his dope

It would be unfair however to assume that the pure food and drug laws are entirely a failure They do give the public considerable real protection A great many manufacturers have the habit of obeying a law If the statutes prohibit certain of their former practices they will aban don those practices on general principles regardless of penalties There are certain cases of infringement also which are so serious that they do get into the newspapers and produce widespread reactions Doctor Bailey s radium water was caught by the pure food and drug author ities after it had caused several deaths and it never will be sold again Yet the laws could be much more effective than they are if the pro ducers could be penalized directly or if the punishments inflicted on the packages we e given nation wide publicity

Inspections and Licenses

Another major front in the fight for the consumers is the widespread practice of inspecting and licensing This controls the conditions sur rounding the production of an article, rather than the article itself It usually is accepted by the courts as part of the so called police power or the right of the legislatures to protect the public health and welfare

The origins of licensing are ancient For generations the states have licensed physicians and lawyers only after proof of professional compe tence and these licenses have been withdrawn on later proof of profes sional incompetence The licensing of innkeepers ferry operators and dispensers of liquor goes back to colonial times

The principle in late years has been extended in many directions Restaurants are subject to sanitary inspection and lose their right to operate if they fall below a minimum standard Elevators steamboats and a variety of other public vehicles have to have annual certificates of safety from the governmental engineers The city health departments lay down strict rules regarding dairy barns and dairy herds in order to maintain the purity of milk The federal government inspects the pack ing houses whose products move in interstate commerce and the purple stamp of the United States on a quarter of beef is your assurance that the slaughtering was done on sanitary premises

The advantage in enforcement of a license system is that it with

draws a privilege rather than enforces a penalty The producer does not have to be prosecuted in court nor does he pay any fine or damages for his misdeeds He may himself appeal to the courts to restore his license if he thinks he has a clear case and can afford to pay the lawyer s fees Otherwise he simply loses his permission to do business temporarily or permanently This while theoretically not a punishment, may actually be the severest punishment of all

Licensing on the other hand has abuses It may be used for personal or political purposes Liquor licenses in many communities appear to be granted or withheld on grounds of party politics or of the personal connections of the saloon keeper There may be no particular concern about giving customers clean beer in hygienic surroundings The systems of milk licensing in the East work as protection for eastern farmers against western competition The milk authorities of New York and Boston admit milk only from dairies subject to their own inspection and they refuse to send out their inspectors beyond limited districts If the milk ordinances were altered the city consumers might be getting milk at lower prices and with no greater danger of infection Licensing under such circumstances may do more harm than good to the public welfare

Standards

A fourth approach to the consumers problems is through the use of standards. A standard is any sort of objective or unprejudiced method of describing an article There may be standards of size or weight standards of taste or freshness standards of shape or structure standards of chemical composition and so on Whenever a particular standard is set up and widely used a new and more accurate terminology becomes available to both producer and consumer Vague nouns and even vaguer adjectives give way to an exact or scientific description The United States Congress for instance enacted a standard for butter Butter thereby ceased to be the oily unctuous substance described in Webster s dictionary and became a food product made exclusively from milk or cream containing not less than 80% of milk fat by weight With the new definition the chance for argument or misunderstanding as to what is butter and what is not has been eliminated

The use of standards does not in itself involve any compulsory control of manufacturing practices If a butter manufacturer chooses to add pork lard to his product the stuff is still entirely edible and can be marketed freely The only requirement is that the label must clearly indicate the presence of pork fat Only when the product is offered for sale as just plain butter does the manufacturer become exposed to legal penalties

The establishment of standards is in other words the fundamental protection for consumers upon which all the other devices for protec

tion rest Without a precise definition of butter previously agreed upon, it is very difficult to get evidence that a particular butter maker in tended to defraud his customers or to establish grounds for seizure of a package of his butter or to withdraw the license from the butter maker s creamery The demand for more and better standards is con tinually arising from every group that agitates for the consumer s welfare Without some sort of measuring stick by which to prove that unfair practices exist all efforts to control such unfair practices prove largely meaningless

The oldest form of standards is the regulation of quantities In the Middle Ages there were many careful definitions of weights and meas ures and officials to enforce these definitions in the markets These definitions varied unfortunately from one jurisdiction to another We still have these definitions and they still vary A bushel in Pennsyl vania, for instance is different from a bushel in Ohio We have no na tional standard for a bushel But the standards are there, and short measures and short weights are grounds for prosecution everywhere

Modern conditions have created a demand for new methods of deter mining quantities The British thermal unit (b t u) is the recognized measurement of heat The kilowatt hour is the basis for the sale of elec tricity We now have a federal container law that settles the proper size of peach baskets and strawberry boxes The decible, a unit for measuring the volume of sound has many possibilities in connection with sound amplifiers and noise deadening devices

The growth of packaging has given rise to a new emphasis on the older standards of quantity The laws require increasingly that the net weight of a container be printed on the label The printing may be in such small type that the customer does not notice it and the customer may never test the weight on his own scales But the statement at least is there as a substitute for the old measurement of quantity on the grocer s scales before the customer s eyes

Standards of taste or tastiness are coming into use The federal depart ment of agriculture has been developing ratings for a large variety of canned goods These involve for instance the size and firmness and freedom from blemishes of the halves of peaches in cans together with the thickness and sweetness of the syrup There are other federal stand ards for such uncanned articles as cheese and sausage Many state governments require classification for eggs in terms of size color and freshness The Florida and California authorities have standard require ments for all the citrus fruits exported from their states

These standards of tastiness are not nearly as simple to maintain as the standards of quantity They can go only so far before they encoun ter the wide variation of preferences among consumers A pound is a pound in all men s minds but what constitutes a first class cheese may

be the subject of unending debate First class cheese to the government s taste may be definitely fourth class in the mouths of certain citizens

There is too the question of the way in which the standards are used Most of the federal standards for canned goods have been voluntary The canner could have his pack inspected and classified on payment of a fee He might get the official rating but only use the information in his dealings with wholesalers or with the banks The customers would still not know the government s opinion of what was in the cans Or in the case of the state government grades there may be definite discrimi nation against out of state products In Rhode Island and several other states the assumption is that eggs laid outside the state cannot be strictly fresh Until these technicalities in application of standards are ironed out the standards themselves may still be relatively useless

A further handicap appears in the choice of terms in grading The producers usually favor extravagance in terminology They prefer to call first grade asparagus colossal the second grade jumbo ' and the third grade extra select This eloquence tends to creep into the official ratings The fourth grade of eggs in Vermont has been called grade A the federal government s No 1 chee e is really number three in quality Considerable controversy has been stirred over the proposal to classify all canned goods on a simple basis of A B and C ratings This is done in Canada But the American canners insist that the consumer in the United States is entitled to descriptive labeling How can a pur chaser tell what he is buying they contend without the aid of adjectives like 'juicy ripe and full flavored ? The consumer organizations argue that as long as these familiar terms appear the purchaser is get ting merely sales pressure with no standard at all

An interesting phase of the whole standards question is the effort toward uniformity in shape or structure This is a type of reform which often wins as much or more enthusiasm from manufacturers as from the general public

Uniformity in screws is an easy example All screws in the United States go in or down by turning clockwise If some screws worked coun ter clockwise as they once did there would be cursing in every factory as well as in every home repair shop Herbert Hoover as Secretary of Commerce, conducted a long series of trade practice conferences in the effort to cut down and simplify a large variety of such mechanical con fusions Sockets for electric fixtures for instance are now reduced to uniformity and everybody concerned is much happier

A program for standardizing sizes of children s clothing is now in progress under federal auspices Detailed studies of tens of thousands of youngsters have been taken with an effort to pick out two or three key measurements that can be used as guides The old baffling classification of suits and dresses by ages is to be abandoned and the sizes are to be

based on definite and standard data The clothing manufacturers are
quite glad to cooperate in this type of standardization They suffer as
much as the consumer from the present vagueness Any customer who
has struggled with hats or shoes supposedly of the same size yet actu
ally different can see that there are further possibilities in this sort of
program

The final type of standardization is that of chemical composition
This is a category which overlaps all of the previously mentioned types
Chemistry can be thought of as concerned with quantity or quality or
structure with equal logic But the distinctive mark of chemical meas
urements is that they involve professional skill and complicated appa
ratus They are quite beyond the abilities of ordinary citizens John
Public can always test the accuracy of such standards as pounds or
feet or cubic contents by his own observations but when he comes to
decide whether a tube of toothpaste is composed of the ingredients
enumerated on the label he simply has to take the word of one chemist
as against the word of another chemist The degree of integrity pre
vailing in the laboratories is the basic factor in standards of chemical
analysis

This question takes a multitude of forms some of which are very
serious When a customer goes into a drug store to buy one of a dozen
varieties of pain killer he does not care particularly about the amount
of liquid in the bottle or its taste He is or ought to be gravely con
cerned over the chemicals he is about to swallow Are there habit form
ing drugs therein and if so in what quantities? Will he be curing his
rheumatism at the expense of his liver or his kidneys? Or is the medi
cine just plain colored water with no curative properties at all? Even if
the label carries a detailed analysis of contents the customer may still
be in the dark Chemical terminology is polysyllabic and unenlightening
and the name of a chemical compound is meaningless without a knowl
edge of its uses and abuses What the drug store customer wants is a set
of standards imposing definite rules as to what constitutes a tonic a
cough medicine and a headache remedy These standards would have to
be drawn up and enforced by laboratory specialists The customer would
still know very little about what he was swallowing but he would have
at least the negative assurance that the medicine was neither dangerous
nor useless in the opinion of the experts

Standards for patent medicines have not yet reached this point The
United States pharmacopœia prescribes exact requirements for so called
pure drugs But these are standards useful only to physicians The lay
man would hardly dare buy aconite or digitalis and dose himself without
advice What he relies upon is a compound medicine containing several
pure drugs and accompanied by directions as to dosage and ailments
These compounds are subject at present to only negative control The

use of certain pure drugs is prohibited the presence of other drugs must be indicated on the label False claims that the compound will cure an incurable disease are also forbidden These provisions give some real protection but the innocent consumer is still left to wander blindly through rows of magic remedies and to swallow whatever concoctions he is willing to pay for

The need for chemical standards is almost as apparent in a grocery store The first steps toward definitions of such compounds as mayonnaise and ketchup are now being made The dry goods store has similar problems What is pure silk as distinguished from silk soaked in a lead bath to increase its weight? What is the difference if any between pure wool' and virgin wool and how much shoddy may either term conceal? The filling stations offer two or three grades of gasoline and oil but the car owners are thoroughly at sea in the presence of octane ratings and S A E specifications What they need as in a drug store is not a detailed statement of the scientific facts which they cannot comprehend but rather a fixed standard of contents and performance that can be ignorantly trusted

At this point the manufacturers are prone to argue that the consumers already have standards to rely upon Those standards are the trade marks and brands Behind each well established nationally known trade name there stands according to the argument all the technical intelligence and integrity of a great business house All the consumers need to do is to pick out a brand that is tried and true and stick with that brand through thick and thin The men behind the brand care much too deeply for their record and their reputation ever to be willing to let the public down A trade name it is contended is a standard that is just as reliable and much more inclusive than any yardstick imposed on industry by outside public agencies

There certainly is truth in this contention Thousands of old established families in this country have been buying goods from old established firms for fifty or a hundred years and the goods are uniformly and unquestionably excellent Certain trade names actually are standards, as good as could be expected outside Utopia Other trade names have symbolized high quality for decades only to be finally sold out without the public s knowledge A new management or a new policy by an old management may result in a thoroughly depreciated product offered under the old label This trading on an established reputation is highly profitable and may go on for years before the public realizes it

Another difficulty with reputable names is that they often involve high prices The concern which has attained a special standing for integrity expects quite naturally to be rewarded for its efforts In fact it has to charge high prices in order to defray the extra costs which integrity itself involves The result is that only the comparatively rich are

able to make use of the rock ribbed protection of the best brand names The middle class and all the poorer people are still exposed to the vagaries of a market where most of the brand names are meaningless and all the subtleties of sales appeal are utilized After all it is tricks of the commercial salesmen that have produced the wide demand for non commercial standards

Laws Against Monopoly

There is one more method of defending the consumers which theoretically at least goes to the very bottom of the matter This is the attack upon monopoly represented largely by the anti trust laws The bearing of these laws on business organizations has been examined elsewhere But their importance in the problems of the consumer is also considerable—particularly in view of certain recent statutes that are altering the general picture

The theory of anti monopoly legislation is familiar The aim is to restore free competition in the market Free competition particularly includes competition in prices The hope is that the big business firms will resort to lower prices—and still lower prices—in their rivalry to capture customers Lowering prices as we earlier pointed out is the one unanswerable almost sure fire method of increasing sales Against a straight price appeal most of the other devices of sales pressure are mere whispers in a high wind If only we could reestablish markets where price competition was the rule many of the problems of the consumers would according to the theory automatically evaporate

Of course as we pointed out, the question of the quality of goods is also involved The price of an article is meaningless without a knowledge of the workmanship or composition of that article The theory of free competition assumes that customers can tell good goods from bad, and will not be fooled by low price tags on products which are approximately worthless This is an assumption which is often far from true in practice

Moreover as we also pointed out, the manufacturers take a directly opposite point of view They dread price competition as a form of anarchy Once the price cutting starts nobody knows where it will end It may result in ruin for all of the competitors A moderate price reduction might they may admit, be advantageous The increase in total sales might more than counterbalance the effect of a lower price per unit But what assurance is there anywhere that a moderate price reduction will not turn itself into a runaway trade war where everybody s receipts are less than his expenses and bankruptcy is just around the corner?

The policy of the big businesses accordingly is to obey the formal prohibitions of the anti trust laws In each field of enterprise there are at least three strong competitors who carefully avoid any mutual agree

ment that might be interpreted as an attempt at a monopoly or a restraint of trade Each concern is a bona fide rival of the others in the eyes of the law But the rivalry between them is strictly confined to competition in sales methods Competition that involves prices is avoided by all hands with almost desperate unanimity

The federal attorney general s office watches for any indication of definite agreements in regard to prices Whenever there is evidence of an agreement the government can prosecute under the anti trust laws But uniformity of prices in most instances is so entirely informal or spontaneous that it escapes the long arm of the law The results of a monopoly exist but the monopoly itself cannot be proved

One great exception to this rule is in the field of patents Patents are artificial monopolies deliberately created by the government as a reward for invention Wherever an industry is based on patents monopoly together with fixed prices can be practiced openly The government under its patent laws is supporting the same type of restraint of trade that it attacks under its anti trust laws The patent law is sometimes regarded as a key point in the price jam which handicaps consumers

Another point at which the government seems to be hamstringing its own efforts against monopoly is the Fair Trade or Price Maintenance Act This permits the manufacturer to fix the prices charged by the retailers of his product Formerly such contracts between manufacturer and retailer were outlawed by the courts as violations of the anti trust laws Now they are openly sanctioned by federal statute The argument for the Fair Trade Act is that it stabilizes retail prices But stabilizing prices is just what the anti trust laws were intended to prevent Under the federal Fair Trade Act and similar state legislation the price jam is also appearing at the retail level Local groceries and drug stores are still competitors but they do not dare compete in prices when the manufacturer says No '

Another interesting modification of the anti trust laws is the recent Wheeler Lea Act It is pro consumer legislation It endows the Federal Trade Commission with a sort of roving authority to stop sales pressure whenever it becomes downright misrepresentation The Federal Trade Commission has been in existence for more than twenty years Its major duty has been to prevent unfair business practices which might lead to monopoly If, however a particular business practice was merely unfair to consumers and not unfair to competitors the F T C had no authority Now under the Wheeler Lea Act, it does have such authority A steady stream of cease and desist orders has recently been flowing from the Commission s offices against the obvious examples of sales ballyhoo A typewriter manufacturer has been forbidden to advertise that using its typewriter will improve a student s grades Radios which are offered as all wave or world wide wave must actually be capable

of picking up broadcasts from all the continents The instances of inter vention by the F T C for the protection of consumers are much too numerous and various even to be summarized The Commission s orders like the seizures of the Food and Drug Administration are not reported in the newspapers But they are effective nonetheless because they are backed up by court injunctions with severe penalties

The powers of the Federal Trade Commission have in the past been seriously curtailed by decisions of the Supreme Court Similar limita tions may or may not be imposed by the Court s interpretations of the Wheeler Lea Act The personnel of the Commission itself may change in such a way as to affect its policies or its activities may be increased or checked by the size of the appropriation which it has to spend For the present however the Commission is making full use of its broad powers with very definite results

The last piece of legislation on our list—and the most intriguing—is the Patman Act It is an expansion of one of the provisions of the old Clayton Anti Trust Law The Act is aimed at the chain stores It requires that a manufacturer shall charge the same prices to all customers in the same trade class If he sells to retailers he must treat all retailers alike Wholesalers can be given lower rates than retailers but all wholesalers must be treated alike The theory behind the act is that chain stores buy in such large volume that they can force a manufacturer to cut prices for them and them alone Then the chain stores having bought the goods at rock bottom prices can afford to sell the same goods at prices lower than those charged by independent stores This low cost due to large pur chases is thought by certain students to be a main advantage of the chain store systems Chain store corporations are not it is contended particularly efficient Their so called efficiency may be largely due to the great bargaining power with which they bludgeon manufacturers

If the reader enjoys solving puzzles he can figure out who benefits by the Patman Act The independent retailers have hoped that it would stop the price wars waged against them by the chain stores but these price wars on standard brands at least are being largely halted by the Fair Trade Act The manufacturers expected that they would be able to get more money out of sales to the chain stores But the chain stores are walking way around the Patman Act by buying up whole factories of their own and pushing their own special brands of goods So many manufacturers no longer sell to the chain stores at all The customers it would appear are not having to pay higher prices at the chain stores, nor are they getting lower prices Whole volumes have been written on the workings of the Patman Act with similarly non committal conclusions

The real import of this statute and of much of the other legislation lies in the fact that one section of American opinion has by no means given up the dream of returning to free competition Their pioneer in

heritance makes them distrustful of regulation by the government in behalf of the consumer or in behalf of any other group The growing fear of European dictatorship increases this distrust They keep on trying to devise some kind of negative law that will cut out certain abuses without increasing the positive power of the state They dread the day when Uncle Sam will go up and down the land imposing standards granting licenses punishing packages and policing everything

Whether it is possible or even desirable to rely upon genuinely free competition as a solution of our problems is a basic question that appears and reappears throughout this book There are two deeply divergent points of view One group sees the solution in terms of a great extension of direct and positive supervision bv the government the other group has pinned its faith on purely negative restrictions which would merely fix the rules for business rivalry and supposedly allow the best product at the lowest price to win the market Both points of view have been elaborately embodied in the legislation for consumers which we have reviewed

CHAPTER 28

CONSUMERS PROTECT THEMSELVES

A third general approach to the whole question of consumers needs and interests lies through some form of voluntary cooperation Consumers according to this view are no longer to act as isolated individuals nor are they to rely for their protection upon the long arm of the government They are rather to form groups through their own initiative By thus pooling their abilities and resources they will be able it is thought mutually to protect each other The idea is similar in its broad outline to the underlying principle of a labor union or of a manufacturers association There are many leaders who believe in this approach to the problems of the consumers It is sometimes spoken of as the cooperative way

Testing Agencies

The cooperative idea in its broader sense takes the form of testing agencies These agencies take in several different forms but they all rest on the double assumption that consumers acting separately are suckers in the market and that consumers acting in groups can know what they are buying and protect each other

The simplest of these organizations is the consumers club This is a group of housewives in a community or neighborhood who meet regularly to study their buying problems The group is often a subdivision of the local Woman s Club The first step in their activities is mutual education They read and discuss the growing mass of books and pamphlets which portray—often in lurid terms—the tricks of sales pressure and the helplessness of purchasers Then they proceed to gather information as regards particular commodities and ways of judging them A good deal of this information is second hand obtained from the reports of other testing agencies But some of it is first hand based on the Club s own careful examination of the offerings of local merchants When a consumers club buys one can of every brand of tomatoes sold in town, measures the contents of every can, holds blindfold tests of flavor for each brand and checks these data against prices charged a new excitement spreads from kitchen to kitchen and from grocery to grocery

These consumers clubs are a new development starting with the depression Their numbers and the range of their activities are not defi

nitely known Many of them are merely gossip groups in a new form Others are strong enough to publish their results for the use of other groups and to send witnesses to argue in Washington for the consumers point of view The possible accomplishments of the clubs are very great They operate so to speak directly on the firing line Their members are the housewives housewives do most of the buying in the United States and housewives are directly and continuously interested in getting their money s worth If these women ever become thoroughly aroused every sales campaign in the nation will have to be adjusted to their wishes

Another type of testing agency is the domestic science course This course is now part of the curriculum in grade schools high schools and universities throughout the land The original purpose was to teach the girls to cook and sew But the domestic science teachers have awakened to the fact that many of their pupils will be buying much of their food already cooked and their apparel already sewed So the emphasis is shifting to instruction in buying The girls become a juvenile consumers club making their own tests by laboratory methods The department of domestic science gets the cooperation of the chemistry department or the biology department in the same school and so adds to the scope and thoroughness of its investigations The studies tie in on the other side with the buying which the school itself does for its lunch rooms or dormitories The findings as regards sheets or refrigerators trickle through to the mothers of the students and to former students of the institution

Cooperative testing has thus become part of our vast machine of formal education Like other types of education it may suffer from student indifference the dull dogmatism of the teachers or the opposition of some local pressure group which limits its activities Yet the school systems are or are supposed to be impartial and public spirited in their approach to current questions Even if future housewives are merely made aware of the existence of a consumer problem some progress has been made

A third kind of testing agency is that maintained by the purchasing department of a great corporation Big business buys its raw materials and its equipment by the carload and can therefore afford to know what it is buying An elaborate laboratory for analyzing steel aluminum and rubber may cost a motor manufacturer $1 000 000 a year but it will save him $10 000,000 a year in better qualities obtained at lower costs When a great railroad buys its lubricating oil that oil is bought on specification after extensive tests of samples Throughout the whole field of big sales to big buyers the opportunity for ballyhoo has almost disappeared Salesmen who deal with the large customers have to be technical experts whose statements can and will be checked in the customers own laboratories

The largest of all large buyers is the government of the United States

and it maintains the largest of all the buyers laboratories This is the famous United States Bureau of Standards The Bureau of Standards draws up a descriptive formula based on its own elaborate research, for each of the thousands of commodities which the government buys This formula is made the basis for competitive bidding by manufacturers The manufacturer who makes the lowest bid and whose goods come up to the requirements of the formula gets the government contract The Bureau of Standards knows just what kind of maple sugar to buy for the veterans hospitals and just what kind of truck is needed by the post offices, and the government gets that kind of maple sugar and that kind of truck at minimum prices Probably no private corporation in the land has greater efficiency in its purchasing or is better armed against the wiles of salesmanship

The Bureau of Standards has been heavily criticized for the secrecy of its procedures It is willing to make public the formulas or standards which it has established but it is not willing to tell the public how particular brands or makes of goods compare when tested by the Bureau's standards The Bureau s contention is that the government s needs are not the same as those of private consumers and that publica tion of its ratings might therefore be misleading The critics answer that such differences as do exist between private and government needs ought also to be publicized The people of the United States they argue have paid for and possess a vast amount of definite information about the qualities of products yet the people cannot get at that information The day may come when the Bureau of Standards will tell all it knows about typewriters and canned peaches and the bearing strengths of steel If that day comes there certainly will be a hurricane of protests from the sales departments and heavy shifts in buying habits on the part of the consumers

Another approach to the problem of testing is through the professional associations The mechanical engineers do special work along these lines so do the fire insurance underwriters but the great exemplars of this method are the American Medical Association and the American Dental Association These societies wage steady campaigns regarding medicinal commodities Certain widely advertised antiseptics have been pilloried as useless or positively friendly to germs Toothpastes have been described by name as poisonous or as containing harsh abrasives that wear out the teeth Indeed there is no toothpaste which completely passes medical examination as helpful in preserving either teeth or gums Toothpastes are like other cosmetics to be used largely for appearance s sake

These associations have of course an economic motive back of their campaigns Every customer who can be warned away from the patent concoctions in the drug stores becomes a possible patient for the den tists and physicians Yet there is no evidence that this self interest actu

ally distorts the associations findings Through their plain statements of established facts more than one corporation selling tinctured water at high prices has had to change its line of goods and its advertising claims

Perhaps the most effective of all the agencies are the membership services—Consumers Research and Consumer s Union These organiza tions have at least one hundred thousand members and are steadily expanding They circulate among their members a monthly guide for buyers The guide discusses topically the various commodities and gives a definite rating to each brand offered in the market Under the heading of radio sets the subscriber reads a discussion of the structural features of radios with the advantages and disadvantages of each Then follows the list of those makes which are definitely recommended a second list of also acceptable brands and a third list of those not recom mended These lists are drawn up on the basis of expert advice and laboratory experiments Consumers Research has its own abrasion testing machine for fabrics its viscosi meter for testing motor oils its fade ometer for testing color dyes and so on Much of the information is marked confidential in order to avoid the chance of a public libel suit by some manufacturer whose products are blacklisted

The attempt to cover all of the fields of consumer interest from insur ance and medicine to liquor and cigarettes is itself a colossal task The tests and ratings on many commodities tend to be incomplete or out of date They have little or no use in the purchase of luxuries where styles and personal preferences are the important factors There is a tendency too to concentrate on goods which are available in the New York City market Purchasers in New Orleans or Omaha often have to choose between brands of gasoline and overalls and canned asparagus which are not even mentioned by Consumers Union or Consumers Research

Yet these membership services have become a standing nuisance to salesmen who handle nationally known products The housewife con fronts a vacuum cleaner agent with the printed statement that his vacu um cleaner is not recommended and the agent s whole day is spoiled The sales department of a refrigerator house instructs its canvassers If they pull out Consumers Research the only thing to do is to talk space Space is the one point that the guide doesn t cover Advertisements by both Consumers Research and Consumers Union are refused by stand ard magazines and newspapers Apparently the reason is that other ad vertisers definitely dislike this type of advertising

The most convincing evidence of the success of the membership serv ices is their imitation by commercial interests Department stores assure their customers that all their goods are tested in their own labora tories a national woman s magazine announces its seal of approval on all the articles mentioned in its advertising a membership service

financed by payments from certain manufacturers makes its debut All of these schemes are obviously partisan and some of them are being prosecuted by the Federal Trade Commission What they indicate is the growing popularity of the whole idea of tests and ratings The consumers are rapidly becoming conscious of their distress and turning to the various testing agencies as a means whereby they can protect themselves

Consumer Cooperatives

The principle of self help for consumers is carried much farther by the consumers cooperatives These are to be distinguished sharply from the marketing cooperatives so widely used in agriculture A marketing cooperative sells goods Its members are producers A consumers cooperative buys goods Its members are customers

The standard form of consumers cooperative is a retail store handling groceries dry goods and the like But it is a retail store with a difference The store is owned by the customers and run for the customers By a basic change in ownership the conflict between seller and buyer is eliminated The seller and the buyer are the same person

This becomes clear when we examine the so called Rochdale principles on which consumers cooperatives are based These are principles worked out in Rochdale England one hundred years ago and regarded as constituting one of the great social inventions of our age

A consumers' cooperative is a corporation under the law Like other corporations it has share holders who have invested in the enterprise and the share holders gather at an annual meeting to elect a board of directors who are to control the details of the business It is the differences between an ordinary corporation and a consumers cooperative which constitute the Rochdale principles

The first principle is One member one vote ' The members are of course, the share holders In ordinary corporations each share holder has as many votes as he owns shares of stock A single investor may out vote all the other stockholders if he owns shares enough In a cooperative it makes no difference how many shares a man may own He has just one vote in any event at the annual meeting This is thought of as a democratic principle It extends to retail shopkeeping the procedure that prevails in democratic government In a city election for instance one voter may own a large share of the land and buildings in the city and pay one hundred times as much municipal taxes as does his poorer neighbor Yet rich and poor it is agreed are entitled to just one vote apiece regardless of the amount of their investment in the city This principle—both as applied to government and to cooperatives—prevents a few rich men from gaining control and overruling the interests of the majority

The second Rochdale principle is A fixed return to investors ' The

investors are, of course the share-holders or members who have furnished the cooperative s capital In ordinary corporations the share holders receive dividends which vary with the profits If profits are very high, dividends may amount to 20 or even 30% of the investment in a single year A cooperative corporation gives its share holders a limited and low return on their money Three per cent is a usual figure The rights of the investor are thus recognized but only in a restricted sense The profits go for the most part to the customers

This leads to the third principle Dividends proportionate to members purchases Cooperatives like other retailers plan to take in more money than they pay out and have a surplus at the year s end This surplus is split up between the members or share holders in an unusual way The division is based on the total amount of purchases by each member If member Jones has bought $100 worth of goods at the cooperative and member Smith purchased $200 worth then Smith gets twice as large a share as Jones in the annual distribution of the surplus A cooperative store will sell its goods to any purchaser whether he is a member of the organization or not But if a purchaser is not a member he does not receive a dividend

This device gets and holds customers People join the cooperative in order to be eligible for the dividend Once they have joined they tend increasingly to buy at the cooperative rather than elsewhere The vision of that rebate coming back to them at the year s end is a powerful inducement The theorists of the cooperative movement hold, moreover that profits should go to consumers rather than to investors Consumers they contend, are the people who really make business possible and profits possible This is a highly controversial question of course, but the Rochdale principles leave no doubt as to where the cooperatives stand

When retailing is organized on Rochdale lines certain distinctive practices or policies also appear One of these is cash sales Cooperatives avoid charge accounts and installment purchases if they can The members realize that any form of credit involves bad debts When the debts of certain members stand unpaid the surplus is reduced and the other members have to take a cut in their annual dividends This policy of cash sales gets rid of one of the devices of sales pressure Cooperative members buy only what they can pay for and cooperative business is made steadier thereby

Another practice is that of little or no advertising or publicity The cooperative members consider that there is nothing to be gained in spending their own money to persuade themselves to spend more of their own money Cooperatives rarely appear therefore in advertising pages Cooperative stores have modest fronts and are located on side streets where rents are low A casual visitor may never guess that a cooperative store exists

in a particular town But the members know where the store is and what it has to sell That is all they care about

A third policy is charging standard prices The cooperatives do not directly challenge private retailers by price cutting They could do so, because their expenses usually are lower But they stir up less opposition by keeping to the usual charges The members of course get what amounts to a price reduction in the form of the annual dividend on purchases

Occasionally the private retailers start a price war on their own account attempting to drive out a cooperative The cooperative follows with equal price reductions until the private retailers have reached the point where they are selling at a loss Then the cooperative will calmly stop selling and advise its members to buy around the corner at the private stores The cooperative does not at all mind closing shop It exists to serve its members If the members are getting impossibly low prices elsewhere the cooperative is succeeding despite its failure When private business finds itself stuck by this peculiar type of competition prices rise again and the cooperative reopens

A fourth policy is that of testing and the maintenance of standards A cooperative organization often conducts its own analyses of the purity or quality of products or it may make use of the findings of other testing agencies The cooperative has its own trade mark—the sign of the two pine trees When this trade mark appears on canned goods and the like it implies that the contents of the package is at least reasonably clean and usable The appeal of the movement is thus not merely in terms of money savings but also in terms of standards of quality

This leads to a fifth cooperative practice which is quite distinctive—expansion only in response to need A cooperative grocery may be doing quite well and be in a position to expand into a line of bakery goods But the existing private bakeries are giving customers good service at low cost Why try to break into a field where conditions are already satisfactory? The cooperative s only interest is in having customers well served On the other hand the members of the cooperative grocery may be full of grievances against the local salesmen of automobile tires So off goes the grocery cooperative into a side line of tires It may end up with a complete garage that overshadows the original grocery business The directions which cooperation follows in extending its activities may seem illogical by private profit standards The expansion has a logic of its own based upon the public need

Equally unusual is the low scale of salaries for the cooperative executives The managers of many of the stores are men of recognized ability They may have been offered or have formerly earned in private business twice the salary that they receive from the cooperatives Yet they go on quite content with their present incomes of $5 000 a year or less Why do they do it? The answer lies partly in the greater stability of cooperatives

There is no such ebb and flow of profits as in private business, nor is there the ever present danger of a change in ownership and consequent dismissal A cooperative once well established is likely to go for decades like a hospital or a library with a fairly steady policy It has a backlog of public good will to keep it going which private business often lacks A man may well forego a larger income now for the sake of this assurance of security in years to come

There are plenty of men too who want to be able to take pride in their work The manager of a cooperative is by definition a public servant He ranks with the minister and the schoolmaster as one of those who stands above the dollar grabbing struggles of the market place This distinction may not be entirely real in practice but it is nonetheless an honor coveted by many The automobile salesman who travelled hundreds of miles each year to attend his college s football games is a case in point He wanted something in his life that he could cheer for with his whole heart Such emotional impulses have dollar values A cooperative manager is often fairly close to cheering for his own job with his whole heart

The last of the distinctive policies is the cooperative s educational pro gram This is taken very seriously by many of the leaders Pamphlets on a wide variety of topics are circulated to members and to non members There are public lectures meetings devoted to general discussion and even summer schools with a fixed course of study One objective is of course to recruit additional members by emphasis on the specific ad vantages of the movement This in the minds of certain critics is the equivalent of the advertising done by private enterprises But the co operatives also have in mind a much broader aim They seek to spread an understanding of the whole political and economic system The sum mer schools especially are gatherings of enthusiastic reformers The pro saic business of getting better beans and bacon through a mutual enter prise is thought of as a mere starting point in a much larger program of community betterment and international well being The cooperatives in England have had their own political party with their own candidates and platforms and the thoroughgoing cooperators' in the United States think of themselves as rivals of the socialists in their devotion to great and revolutionary ideals

The cooperative movement has however certain distinctive limita tions which appear in actual practice It is not a perfect embodiment of all economic virtue It has trouble for one thing with labor and labor unions A cooperative of any size employs clerks and other wage earners These people fare no better at the hands of a consumer minded manage ment than they do in ordinary enterprise A raise in wages is resisted just as stubbornly and for the same reason High wages mean lower divi dends and consumer owners like investor owners want all the dividends that they can get It helps a little to explain to the employees that they

can also join the cooperative as members and get a slice of the surplus in that way But the employees still know that an increase of one cent an hour in wages would amount to more for them than the largest dividends which they might hope for as consumer members The great English co operative movement with its proud record as the friend of the poor had to face a serious strike of its employees before it consented to pay usual wages to its workers

The cooperatives also have an Achilles heel in the matter of taxes Taxes on the net profits of corporations are now well established These taxes are often progressive—the higher the profits the higher the tax rate The cooperative corporation contends that it makes no profits at all and therefore should not pay a profits tax The money which it has left over at the end of the year the cooperative calls a surplus not a profit But just what is the difference between a surplus distributed to consumer owners and a profit distributed to investor owners? So far the cooper atives in the United States have succeeded in their argument and been exempt from income taxes But private business contends that this is a gross injustice and amounts to a government subsidy for one type of en terprise against another This criticism seems in part at least to be well founded

There is too, the problem of getting the cooperative members to do their job as owners of the undertaking When the annual meeting is held, half or three quarters of the membership may not appear Those who do attend may have no definite notion as to what should be done The fine theory of an organization of consumers by consumers for consumers does not always work in practice Control in such cases falls into the hands of a small clique which may lose sight of the general interest and merely perpetuate its own authority Just as in political elections popular indif ference may lead to machine dominance The prevention of such dry rot is part of the purpose of the cooperative educational program

Another weakness of the movement has been its tendency to get en tangled with other movements In some European cooperatives the Social ists have gained control others have become allied with the Catholic church. In our history the Knights of Labor have sponsored consumer co operatives, and so has the Granger movement When any such alliance is consummated the cooperative becomes a battle ground of controversy and the original purpose is lost in partisan bitterness The surplus which should be divided among the members may be siphoned off to support other reforms In Finland the cooperatives split into two completely sepa rate movements due to differences in political opinions The leaders in co operative endeavor have been very slow in learning the necessity of stick ing to their job and leaving other ideals to other idealists

The most trenchant attack of all lies in the query, Why are there so few cooperatives in the United States? The cooperative idea has been current

for one hundred years Why has it so few adherents in America? There are millions of consumers in this country who have never even bothered to inquire about it In Europe it admittedly has won large victories The British cooperatives for instance have handled more than 10% of the entire retail trade of the United Kingdom The proportion for the United States has been less than 1% A comparison with the Scandinavian co operatives would be even more striking

The plain answer seems to be that until recently at least there has been much less need for cooperatives in America The people of the United States have enjoyed the highest level of real income in the world and they have had high hopes of even higher levels of income in the future They have centered their attention therefore upon their earning rather than their spending If only there is money enough coming in one can buy his way up through the market to any quality or variety of goods he may desire The residents of Palm Beach and Park Avenue have no con sumers' problems and no interest in consumers cooperatives A great many Americans have thought of themselves as on their way to great wealth with no time to spare for small economies in purchasing

On the other hand American merchants and American manufacturers have despite their faults, done a better job under private enterprise than many European business men The middle class public in the United States has been getting comparatively better goods at comparatively cheaper prices It has been pointed out with some amusement that the much heralded achievements of cooperatives in Sweden have largely re sulted in giving to Swedish consumers for the first time a level of prices and quality that Americans would regard as commonplace

Only in the last few years has the need for cooperatives been seriously and widely felt by our consumers One contributing factor has been the rapid growth of high powered salesmanship Cooperatives are a firm bul wark against that The other factor is the stickiness of the adminis tered prices Wages go down farm incomes go down but the prices of manufactured goods do not go down Cooperatives can help in this dilemma They at least cut down the price of manufactured goods by the amount of the consumer member s dividend When every penny counts as it has during the depression a saving of 5 or 8% on every purchase is something to get organized about

If America should return to the gay prosperity of the 1920s the co operative movement would probably relapse into its earlier insignificance But with conditions as they are the movement is rising rapidly The ad vance is irregular according to the need and opportunity The farmers in their years of distress have been turning to consumers cooperatives to buy their gasoline feed, fertilizer and agricultural implements The re tired oldsters of Southern California have gone in for cooperative groceries along with other reforms People with Scandinavian backgrounds who

know about the movement in the old country have made the states of Minnesota and Wisconsin into hotbeds of cooperation College communities are trying out the idea So are radical white collar groups in the large cities How far and in what direction it may spread is unpredictable But that it will spread is taken for granted unless conditions greatly change by both opponents and proponents of the movement

Expanding the Cooperative Idea

We have spoken so far of consumer s cooperation as confined to retail stores But it is by no means so limited It is possible to apply the Rochdale principles to almost any type of economic action

We have burial societies which meet funeral expenses on cooperative principles Cemeteries are cooperatively owned so are hospitals Cooperative insurance societies cooperative telephone systems and cooperative electric power lines have been developed in the rural areas

Cooperative housing is being widely advocated and occasionally practised The tenants in a block of residences own shares in the owning corporation elect directors to control the property and divide the yearly surplus in proportion to each tenant s rental payments If a tenant moves away his shares and membership rights are sold to the new tenant

Cooperative banks or credit unions, have been organized under both state and federal laws The members deposit their savings in the bank and the savings are loaned to other members The bank is entirely owned and managed by the membership and membership is strictly limited to a group of mutual acquaintances who know and trust each other For poorer families in settled communities cooperative banks are a godsend They furnish loans to meet such sudden emergencies as accident or sickness The loans are made at low rates of interest and save the poor from the depredations of loan sharks and small loan companies

The cooperative principle is also expanded upwards from retailing to wholesaling and from wholesaling to manufacturing There are at present in the United States a score of cooperative wholesale houses These wholesale cooperatives are owned by the retail cooperatives Each retail society has one vote and the surplus or profits is divided according to the amount of each retail society s purchases The wholesale cooperatives may unite in ownership of a manufacturing plant making their own tires or lubricating oil or canned goods The Swedish cooperatives own flour mills galosh factories and an electric light bulb plant The British wholesale cooperatives have their own tea plantations in Ceylon At each stage in the pyramid the Rochdale principles rule The members of a manufacturing cooperative are wholesale cooperatives and so on down

There is no reason in the minds of some enthusiasts why cooperation should not ultimately control all manufacturing and all selling of all commodities Everything would be owned and managed by the con

sumers Since the great body of consumers includes everybody every body s interests would be cared for The basic purpose of all manufacturing and all distributing is to meet the needs of the consumers Why not recognize this fact in all of our economic organization? We would thereby escape the competitive greed of private ownership on the one hand and the dictatorship of a paternal government on the other Consumers co operatives are offered as the great and happy middle way

The day of the cooperative state has obviously not arrived as yet in the United States Nor are there more than a few hundred thousand citizens who have ever even heard of the idea All that we need to realize for the present is that the cooperative principle has in theory almost no limits It might conceivably be applied to well nigh any phase of human endeavor

Whether it ever will be so applied in practice—and if so with what results—must be left to the long rivalry and jostling of pressure groups in future years

PART VIII

Labor

CHAPTER 29

INSECURITY

For the great mass of people security is a matter of employment In a society in which men instead of making the goods their families need make money and with their money income buy for their own use goods made by unknown hands the economic comfort of a family depends more upon its ability to command an adequate money income and upon its pecuniary thrift than upon its efficiency in making useful goods [1] For most workers the loss of a job is *the* great tragedy for with the job goes the monetary means of providing for the basic necessities of life

Uncertainty is ubiquitous it is of the very essence of modern existence and no one be he employer or employee be he industrious or indolent can completely protect himself against all the risk to which he falls heir The risks which are of significance however are those which cannot be provided for adequately The average workman is incapable of accumulating a monetary reserve of sufficient size to protect him against the loss of income which results from a protracted period of unemployment If savings have been accumulated they are soon exhausted living standards sink to lower levels and the nutritional and health needs of the family are neglected [2] Because of conditions beyond his control and largely beyond the control of the men and institutions for whom he works the employee is from time to time deprived of all sources of income

Definition of Unemployment

An unemployed person is one who is seeking work for wages but is unable to find any suited to his capacities and under conditions which are reasonable judged by local standards [3] A person by this definition who because of extreme age physical impairments or mental deficiencies is incapable of functioning as a productive worker is not technically unemployed but *unemployable* These unfortunates constitute a social rather than an economic problem Their involuntary idleness is not attributable to economic maladjustments It is also necessary to weed out from the unemployed category the work shy that is those to whom work is an

[1] W C Mitchell *Business Cycles—The Problem and Its Setting* (National Bureau of Economic Research New York 1927) pp 62 63

[2] Social Security Board *Social Security in America* (1937) p 3

[3] B S Rowntree and B Lasker *Unemployment A Social Study* (Macmillan and Co Ltd London 1911) p xiii

exceedingly unpleasant experience to be avoided at all costs Unemployment then is the desire for and the willingness to work coupled with the inability to find gainful employment under reasonably acceptable conditions [4]

The Incidence of Unemployment

The absence in the United States of continuous official unemployment statistics is attributable to several causes not the least among these being the reluctance until recently of the national government to accept unemployment as a social responsibility As long as involuntary idleness is accepted as the exclusive concern of the persons directly affected, the government is under no compulsion to provide unemployment statistics Even the union organizations were remiss in this matter It was not until 1930 that the American Federation of Labor accepted the obligation of maintaining satisfactory unemployment records Fortunately this dearth of official information has partially been offset by the numerous competent unofficial investigations which have been made by students of the labor problem [5]

ESTIMATED VOLUME OF UNEMPLOYMENT [6]

1923	minimum volume	1 532 000
1925	minimum volume	1 775 000
1927	minimum volume	2 055 000
1929	average volume	1 813 000
1931	average volume	8 634 000
1933	average volume	13 176 000
1936	average volume	10 940 000
1937	average volume	9 520 000
1939	average volume	11 900 000
1940	average volume	8 130 000

The country has yet to experience the satisfaction that comes with a period entirely free of unemployment Even during World War I when

[4] The latter part of the definition—under reasonably acceptable conditions—creates an area in which opinions may both differ and come into conflict What specific wage would constitute a reasonable wage? Are workers who refuse employment because it entails replacing men on strike unemployed? Too who is to determine when conditions are reasonable?

[5] Some of these studies are W A Berridge *Cycles of Unemployment in the United States 1903 1922* (Houghton Mifflin Company Boston 1923) H Hart *Fluctuations in Employment in Cities of the United States 1902 1917* (Cincinnati 1918) L Wolman and M B Givens in *Recent Economic Changes* P H Douglas *Real Wages in the United States 1890 1926* (Houghton Mifflin Company Boston 1930)

[6] The figures for 1923 1925 and 1927 are from L Wolman *Recent Economic Changes* Volume II p 478 figures for 1929 1931 and 1933 are from R R Nathan Estimates of Unemployment in the United States 1929 1935 in *International Labor Review* January 1936 figures for 1936 1937 and 1939 are from D Ander on *Taxation and Recovery* figure fo 1940 is from A F L estimate in *New York Times* December 6 1940

the bulging pay envelopes of skilled workmen created the illusion of a general labor shortage some 1½ million men were without jobs Even during the halcyon 20s, when 'poverty had been banished from the United States the number of workers without gainful employment averaged 6% of the total number employed Had the investigation been extended to include the 30s the percentage would obviously have been markedly greater Many students now in college (1941) would probably have difficulty recalling a time when there were fewer than 7 million men unemployed

It should be remembered however that the 6% referred to above is but an average around which fluctuations occur In better years the percentage decreased in leaner years it increased Nor should one infer that this 6% comprised the same people year in and year out Although the absolute number of unemployed may exhibit a high degree of stability over some given period of time the composition of the group changes Some workers leave to rejoin the gainfully employed just as others fill the places vacated in the ranks of the unemployed The length of the period which any given person spends in involuntary idleness will vary with individuals Some workers may be unemployed for a relatively short period of time while others less fortunate may find themselves in the army of the jobless for periods of great duration But whatever the length of unemployment serious hardships are the likely result

It must be remembered that unemployment does not affect all industries alike Some industries just as some occupations have a higher incidence of unemployment than do others The Social Security Board stated that in July 1934 64 9% of all persons engaged in the construction industries were unemployed, 38 1% in the service industries 37 4% in mining 36 2% in railroads 27 4% in manufacturing 19 5% in trade 5 1% in public service and 1 1% in agriculture '[7] Within the manufacturing group of industries a wide dissimilarity of employment experience is to be found Employment decreased by 53 2% in the machine industry but only 15 4% in the leather industry There is also a higher incidence of unemployment in those industries engaged in the manufacturing of durable goods than in those manufacturing non durable goods[8]

An uneven distribution of unemployment also marks the incidence of unemployment among skilled workers when compared with unskilled workers The unskilled worker feels the heavy hand of unemployment more than does the skilled worker One additional observation can be made the least efficient and the least desirable among the labor force are ordinarily separated first when the vicissitudes of business compel an employer to reduce the size of his labor group

[7] Social Security Board *Social Security in America* p 57

[8] The decline in employment between 1929 and 1933 was 48 4% in the durable goods industries and only 19.4% in the non durable goods industries

Technological Unemployment

The separation of workers from jobs which customarily accompanies the introduction of machines or the initiation of new processes of a non mechanical nature is termed technological unemployment The question which this form of unemployment poses is not whether *labor saving* machinery economizes in the use of manpower per given volume of product Labor saving machinery by definition makes such a question redundant The real issue is whether technological innovations reduce the *total* de mand for labor and in consequence cause *permanent* unemployment

The fact that the problem is so frequently made to assume the form of a conflict between men and machines accounts for much of the acrimony that characterizes discussions of technological progress There is a tend ency to insist that the employment situation subsequent to the introduc tion of a new technique is a mechanical consequence of the use of the machine itself Actually the effect which a new process will have upon employment opportunities within the foreseeable future can only be answered in light of the economic situation existing at the time of its acceptance

In 1931 in Manchester New Hampshire the introduction of the auto matic cigar making machine made obsolete the older hand process The immediate effect of this change in the technique of production was that some 600 skilled male hand operators were replaced by some 200 female machine operators Evidently the skill and the experience of the older craftsmen offered them no special qualification for service in the mechan ized process

Five years after the introduction of the automatic machine a survey was made of the employment experience of the displaced workers [9] During the five years following the lay off the displaced cigar makers *as a group* were without work 52% of the time and this despite the fact that they were both able and willing to work and were actively seeking employment At the time the survey was made approximately 13% were self employed cigar makers many more in the interim had tried self employment but had failed Another 17% were employed by others in the cigar industry others were no longer cigar makers but worked at semi skilled or unskilled jobs in the companies that had mechanized their plants 25% spent the entire 5 years in involuntary idleness Jobs which the more fortunate did secure were typically casual and they experienced many periods of unem ployment usually of long duration [10]

Care must be exercised lest more be read into this survey than can

[9] D Creamer and G V Swackhamer *Cigar Makers—After the Lay Off* N R P Report No L 1 December 1937

[10] Other illustrations of the effect of mechanization upon di placement of workers can be found in A Epstein *Insecurity A Challenge to America* (Harrison Smith and Robert Haas New York 1933) pp 228 241

actually be found there What the survey tells is the employment experience of a specific group of workers under a specific set of circumstances The cigar industry is a declining industry the men were let out at the beginning of a severe depression in a community that was especially affected by the depression Although it is quite evident that these craftsmen would not have been reabsorbed in the cigar industry it is conceivable that their opportunities for employment at other tasks would have been greater *if* general business conditions had been better The extent of the unemployment facing displaced workers tends to be controlled by the economic conditions under which the change takes place and by the characteristics of the worker affected [11]

The traditional analysis of this problem of technological unemployment may be likened to a jig saw puzzle which when finally assembled leaves no section unaccounted for nor any ill fitting ragged edges exposed [12] Given sufficient time and a competitive situation the maladjustments incident to the introduction of the newer technique would be corrected It was mandatory upon entrepreneurs if they aspired to retain or better their market position to be unrelenting in their quest for cost reducing innovations The economies thus achieved brought about a commensurate fall in per unit price The number of units of the good sold would increase with the result that the workers originally displaced would be reemployed If on the contrary the demand should prove inelastic purchasing power was released which could be used to satisfy other wants The increase in the demand for these other goods would stimulate an expansion in the volume of their production which in turn would require the hiring of more workers This analysis recognized the *temporary* unemployment incident to the period of readjustment The proclivity to emphasize the ultimate long run results however developed on the part of some expositors a complacent acquiescence in the short run effects of technological progress

Forces Militating Against Ready Readjustments

The economic system is neither purely competitive nor perfectly monopolistic A fusion of these has occurred yielding what is termed a system of monopolistic competition The influences exerted by the competitive forces are consequently less pervasive more subject to limitations frictions which were present even when competition as practiced accorded more closely with competition in theory are now more pronounced Readjustments which under the competitive scheme took place in accordance with a definite discernible pattern now follow a less predictable course

[11] The effects of technological innovations upon employment as treated in David Weintraub The Displacement of Workers Through Increases in Efficiency and Their Absorption by Industry 1920 1931 in *Journal of the American Statistical Association* December 1932

[12] In a treatment of the long run effects see P H Douglas and H Director *The Problem of Unemployment* (The Macmillan Company New York 1931) pp 138 139

The readjustments were to be consummated in ' the long run " It should be noted however, that this phrase is not a span of statistically measurable duration It is a time concept of convenient elasticity capable of being stretched to encompass periods of varying lengths He who has been displaced by a machine may find that the long run is just a bit too long for limited resources to weather or courage to endure

The stickiness which has developed in the price mechanism makes less tenable the assumption that the economies resulting from improved pro cesses will be passed on almost immediately to consumers in the form of lower prices One can predict with less certainty the effects of mechani zation upon prices In the industrial field there are numerous examples (steel rails aluminum many types of standard agricultural equipment typewriters) of prices which are administratively rather than competi tively determined [13] When prices are administratively set the effect which a technological innovation will have upon price is not mechanically deter mined but is the result of management s estimate of what effect a change in price policy will have upon profits

If the machine be of the labor saving type the immediate effect of its introduction will be to increase the supply of labor A new equilibrium at full employment can be achieved only if a downward readjustment in wages occurs But wages especially of skilled unionized workers are among the least flexible of prices The reluctance of displaced workers ' to sell their services for nothing or if they are union men to break the union scale protracts the time period necessary to the establishment of a new equilibrium at something approximating full employment and thus slows up the reabsorption process

The logical sequence assumed in competitive reasoning—enhanced profits greater savings expanded investments full employment—calls for closer inspection What if the greater savings should by causing a fall in the rate on interest speed up the rate at which labor saving machines are being introduced into industry? For some indeterminate period the pace at which men are being displaced would exceed the speed at which they are being reabsorbed Maladjustments would become more widespread and deepseated correctives more complicated What if man agement freed from the discipline imposed by the sale of equities through the securities market should elect to expand plant equipment by plowing back earnings only to find that purchasers could not be found for the increased output at the existing level of prices? Unless this price proved more flexible than many the funds invested in the expanded plant are lost And finally investments depend not only on the abundance of loan able funds but also on the willingness of business men to make capital

[13] For a discussion of price inflexibility and some of its implications see G C Means *Industrial Prices and Their Relative Inflexibility* 74th Congress 1st Session Senate Docu ment 13 1935

commitments And this latter decision is made in light of the prospective rate of profit

To damn the machine does not solve the problem One would but ignore demonstrable fact were he to deny the decisive contribution made by the machine to the material wellbeing of society Yet there is a danger in overemphasizing the happy long run results The complex problems of the readjustment period are apt to be forgotten or if not forgotten accepted with complacency The increasing efficiency of American industry between 1920 and 1939 not only resulted in more goods but in a high rate of displacement Over 3 million wage earners in manufacturing alone were displaced by technological and managerial innovations during this period And despite the increase in the physical volume of production there were 841 000 fewer workers employed in manufacturing in 1928 than in 1920 Thus even though more goods and services were available at the end of the decade than at the beginning and although many of the displaced workers found employment in other fields of endeavor millions of workers were called upon to endure the suffering which always accompanies a period of readjustment And when it is recalled that in 1929 there were 1 813 000 unemployed it is conceivable that some of these men when displaced never again found gainful employment Society s problem is to develop a method through which it can retain the advantages which come with technological improvements and at the same time eliminate the suffering incident to the period of readjustment

Cyclical Unemployment

The separation of workers from jobs which results directly from the contraction in general business activity during the depression phase of a business cycle is termed cyclical unemployment

The extent of this form of unemployment depends both upon the intensity of the depression and its duration The cyclical down swing in business announced by the stock market crash in 1929 had by 1931 separated some 5 million men from gainful employment Two years later this group was estimated to have increased to 13 176 000 Between 1930 and 1933 25 6% of those normally engaged in non agricultural pursuits were without work and in the darkest days of 1933 this percentage rose to 33 These were days when men accumulated and wealth decayed

This unemployment was not evenly distributed throughout the country but varied as between sections In 1933 Georgia with a predominantly agricultural population had a smaller percentage of its total labor force unemployed than did highly industrialized Michigan And though the unemployment percentages of these two states represent the greatest deviations from the average the incidence of unemployment tended to vary directly with the degree of industrialization attained by the section under consideration Too the amplitude of fluctuation in employment differed as

between types of industries and kinds of occupations Cyclical unemployment is more marked in the capital goods than in the consumers goods industries greater among unskilled than skilled workers more severe among the inefficient than the efficient

This uneven distribution of the incidence of cyclical unemployment is traceable to several causes The producers of capital goods customarily approach a crisis with a labor force adjusted to the production requirements of a period of expanding prosperity Business encouraged by the opportunities for profitable investment has whipped the capital goods industry into a state of great animation When the depression strikes the high hopes of business for the morrow give way to uncertainty caution yields to hesitancy and safety is sought by curtailing capital commitments The producer of capital goods can at best hope for little more than replacement orders And if the depression should be of long duration even this crumb may be denied Other industrialists are engaged in the manufacturing of durable consumers goods such as automobiles This type of commodity has a fairly elastic life span Many who would ordinarily turn in their cars every two years will when pinched by a depression make the old buggy last for several more years This ability to postpone a purchase affects the demand for the good and in turn the volume of employment in the industries devoted to its production Industrialists generally can control their volume of production more effectively than can farmers If confronted by a downward spiral in prices the industrialist can readjust his production schedules reduce his labor force and curtail his purchase of raw materials The farmer on the contrary operating a farm rather than a business may in the face of declining prices strive to compensate for the fall in per unit price by expanding his volume of production The farmer s employees are apt to be intimates possibly relatives who are probably receiving part of their pay in food and lodging These workers are not just so many numbers to be added and subtracted they are separated from their jobs with more reluctance than is true of a more business like business

Seasonal Unemployment

The separation of workers from jobs which is caused primarily by the influence which the seasons exert upon the economic habits of man is termed seasonal unemployment Nature moves through its seasons in an unvarying sequence This rhythm of the seasons affects branches of industry such as construction mining and manufacturing of agricultural equipment which are dependent upon the weather Custom plays its part also It has ordained that man shall crown his head with straw in the summer and felt in the winter The demand for laborers in these seasonal industries is subject to great variations periods of full employment alternating with others of idleness

Workers in some of these industries—construction for example—depend for their annual incomes upon the employment the ndustry provides during its active months They constitute a labor reserve to which the employer can turn when business again expands In other cases—wheat harvesting for example—the working force consists of the casual migra tory worker whose income is the result of moving from job to job

The loss caused by seasonal unemployment is not restricted however to the workers although they are probably the least able to bear the burden involved the employer also loses His capital investment by remaining idle during these slack months also joins the army of the unemployed

"The Irreducible Minimum'

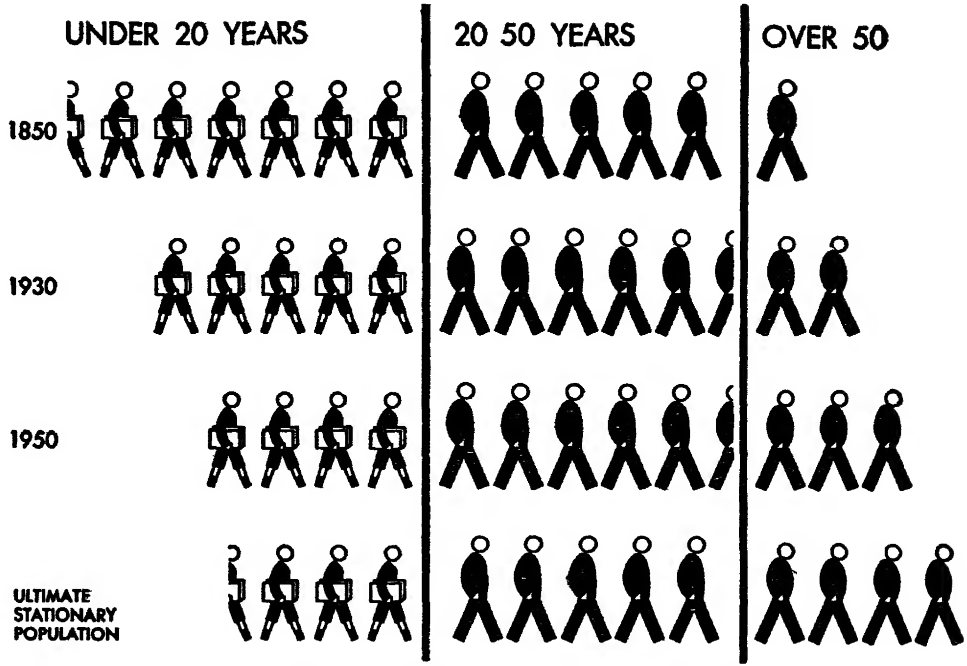
The dynamic character of society requires that the redistribution of the labor force be a continuing process if unemployment is to be mini mized New industries arise and old industries die And workers if they are to be continuously employed must move speedily and easily to where their services are in demand If this shift cannot be achieved expeditiously there will always be at any given point of time some men without employ ment In the United States as is true of other free economies the labor market has not as yet reached that exalted state of perfection where an equilibrium at full employment between the demand for and the supply of labor is always maintained This condition is a concomitant of a free labor market and will continue to be present as long as men are free to move from job to job If this irreducible minimum of unemployment does not exceed 2% of the total volume of employed it is accepted as normal If on the contrary this percentage should increase and persist at this higher level for some time it is interpreted as a critical symptom of a basic economic maladjustment

Old Age

To spend his declining years in want is not a pleasant prospect for anyone to contemplate Yet as society has become more industrialized this has been the inescapable fate of many aged persons It was not always so There have been social organizations in which man and woman too continued a useful productive member long past that age which is now considered the dead line As long as he could turn out useful goods his artisanship was wanted regardless of his age And on the farm old age was not a thing to be dreaded but a fact of nature like the setting of the sun Old age today is less a problem of debility and more one of economics

In 1930 7 78% of the male population was 65 years of age or over but these older people accounted for only 5 15% of all males 16 years of age or over engaged in gainful employment The percentage of males over 65 employed in specific occupations diverged in both directions from the

OUR AGEING POPULATION



Each symbol represents 8 per cent of the population

[From Hacker Modley Taylor *The United States A Graphic History* (Modern Age Books Inc) By permission of Pictograph Corporation]

average percentage engaged in gainful employment In farming the percentage was 8 85% among retail dealers it was 6 5% In contrast the percentage of elderly people employed as machinists was 2 61% as miners 2 34% and as cotton mill operators 1 32% It was estimated that in 1930 some 1 500 000 persons over 65 were unable to provide for themselves by 1936 it was concluded by the Committee on Economic Security that this number had increased to about 7 5 millions

Superannuation however isn t restricted to workers approaching their allotted three score and ten Many industries particularly those of larger size refuse employment to those beyond some predetermined age [14] In some cases this dead line has been set as low as 40 or 35 years a time of life when one isn t exactly hoary with age The absence of a formal dead line is no assurance that discrimination against older workers is not practised They may be excluded through resort to the simple expedient of hiring only younger men

Such evidence as has been gathered does not support the claim that the dead line was introduced because men beyond the designated age were incapable of doing the work required Nor does it substantiate the contention that older employees have a higher incidence of injuries The most probable reason is to be found in the set up of most private pension systems and in the extension of group insurance plans The typical private pension system requires that the worker to establish his eligibility for benefits must have been in the employ of the company some 25 years An employer hesitates to hire a man whose chances of continuous employment for the requisite period are few To accept an older worker in the knowledge that he will be unable to establish his eligibility by the time he is compelled to quit work may be inviting labor trouble The employer even though the choice does not rest with him may find himself accused of being a hard bitten inconsiderate old Scrooge for denying the worker a pension Too the size of the premium which a company must pay under a system of group insurance varies directly with the average age of the group insured A company which through the use of a dead line maintains a low average age enjoys a financial advantage

It may be argued that if workers would anticipate old age by practising the adage that a penny saved is a penny earned old age would then become a time of peace and comfort Even if this were true and that still remains to be seen old age is a long long way off for a youth of twenty And the rainy day for which man is charged to save often proves a day of deluge Before old age is reached he may face periods of unemployment depressions may eat away his bank balance protracted periods of sickness may dissipate his savings in short old age is but one of the many risks which the worker is called upon to bear

[14] This should not be interpreted to mean that the company discharges its employees when they reach this age but that in hiring *new* workers older men are not accepted

The Effects of Unemployment

(1) *On the Worker*—Unemployment if prolonged strips the worker of his most valuable attribute—his skill To retain his proficiency the worker must continuously practise his craft Months or years spent in idleness rob his hand of its dexterity the sensitive touch of the master gives way to the all thumbs bungling of the neophyte Technological innovations are more immediate in their effects upon skill As was illus trated in the case of the cigar makers the years spent in mastering the craft were rendered worthless by the introduction of the mechanical cigar maker And since skills are ordinarily not transferable the loss is a permanent one The displaced worker if he should be reabsorbed into industry usually returns as a semi or unskilled employee The resulting decrease in his income necessitates a readjustment in his mode of living Comforts to which he and his family have become habituated must be abandoned The satisfaction that was his in the knowledge that he was an aristocrat among workmen is no longer his to enjoy This loss of skill cannot be measured in monetary terms alone the psychological effects of this loss upon the worker must also be considered

Protracted unemployment affects the morale of the worker Constant but futile search for employment eats away the self confidence which once was his The daily fruitless scanning of the men wanted column the endless chasing down of groundless rumors of work the continuing rebuffs ultimately make him question his own competence Soon he comes to believe that it is he who is at fault Hope yields to despondency and the search for work is abandoned If this lack of regular disciplined employment should continue the unemployed person may finally become unemployable He is no longer a worker without a job but a man no longer capable of working

(2) *On the Family*—The loss of income which accompanies unemploy ment exacts its toll Savings are soon exhausted The family sees the innumerable sacrifices made to acquire its few possessions coming to naught Insurance policies are surrendered mortgages are foreclosed forcing homes to be given up The family in its search for less expensive accommodations settles in inadequate overcrowded quarters Nutri tional and health standards are lowered to fit empty purses

The family may be unable to withstand the subtle erosion that stealthily undermines the foundation upon which it rests As suspicion and conflict replace understanding and harmony family disorganization is inevitable Poverty and want like a two sided file fray tempers suggestions, kindly intended become bitter criticism complaints degenerate into resented nagging Either the husband or the wife, no longer capable of continuing the struggle may seek an escape by abandoning the home

Nothing illustrates better the devastation wrought by unemployment

than the 200 000 to 300 000 youths who roamed the country homeless destitute and demoralized in the early years of the 30s Many not desiring to be a burden to families no longer able to support themselves took to the open road others seeking in vain their first jobs in a world which at that time had no need for them turned hoboes These boys and girls drifting aimlessly through the country cast a long and ominous shadow over the land

(3) *On the Employer*—Empty pocketbooks are not the stuff of which prosperous business is made Unemployed men have only the desire for the merchandise that is collecting dust on the shelves of merchants and desire is not enough Unless consumers have the monetary means to effectuate these desires business stands impotent When men are turned loose to swell the army of the unemployed machines follow them Overhead costs increase as production declines and even though the employer should padlock his door he cannot lock out the mounting costs It has been estimated that in 1922 the cost of idle overhead amounted to $250 million Unemployment also penalizes industry in a less obvious manner Workmen always under the shadow of unemployment slacken their pace in the hope that they can by this device prolong the work they have Efficiency is thus sacrificed on the altar of possible future unemployment

(4) *On Society*—If vast numbers of workers are sentenced to prolonged periods of enforced idleness by a malfunctioning economic system not only are resources wasted but the discontent of the unemployed matures into a spirit of rebelliousness A nation which has yet to produce sufficient to assure everyone a comfortable standard of living cannot afford the luxury of permitting its manpower to run to waste Each day that men are without employment is a day of irreparable loss Goods and services are too sorely needed by too many people for any society to accept this thriftlessness with complacency Workers when busily engaged at some remunerative occupation rarely, if ever question the status quo yet these same men turned loose by a depression to swell the ranks of the unemployed vent their despair in vehement attacks upon the very administration which some few years before they voted into power Economic messiahs promising a new and fuller life under their special dispensation find in the confused hopelessness of the unemployed a most receptive soil in which to plant their seeds Idle youth discouraged and distraught has often made up the phalanxes of the multicolored shirt organizations One has but to recall the eagerness with which the elderly greeted the promises of Dr Townsend to grasp the political significance of penury in old age A society which fails to solve the problem of widespread involuntary idleness is a society which is courting disaster

Remedial Action

In order that the suffering experienced by those millions set adrift by a depression can be alleviated two forms of vigorous action are necessary One is preventive the other remedial If the forces making for a depression can be identified before they have gathered full momentum and if effective techniques for their control can be devised the amplitude of cyclical fluctuations can be reduced However if preventive action is to be effective it calls for thorough knowledge and what is more courage to act upon that knowledge quickly and decisively As information concerning the cycle increases those factors which reenforce the upward swing may be isolated and subjected to conscious control Thus the interest rates which contribute their bit to what has been termed the dance of the dollar may through more competent and effective central bank action be brought under greater control But if one has learned anything from the past he should not be overly sanguine concerning the future effectiveness of preventive action

If cyclical fluctuations are accepted as inherent in the competitive capitalistic system remedial action must be relied upon to mitigate the suffering induced by a depression A program of action may well start with the premise that no one denied by a depression the opportunity of earning a livelihood shall be permitted to go hungry or exist inadequately clothed or housed This declaration of faith creates objectives for which to strive but does not answer the question of how they can most effectively be achieved

The dole that system under which the unemployed are given a direct money grant based upon the needs of the recipient has its defenders Aside from the unpleasant fact that many who accept this public charity do so with a deep sense of humiliation it is questionable whether any relief system which permits a sizable group of the citizenry to live in idleness is wise social policy Some unemployables may find if they were to search that they sprang from a marriage of idleness and the dole It is not only what the dole does to those to whom it is paid that is regrettable but more to be deplored is the tremendous waste of productive power which it sanctions If society accepts the obligation of providing for the victims of a depression it would appear better economy if relief payments were made conditional upon the performance of services beneficial to the community It may be objected that this suggestion would entail a greater monetary expenditure on the part of the government If the costs be reckoned only in the direct monetary outlay involved the objection would be valid but if one were to set against the money outlay the goods and services which would result the skills that would be preserved the satisfaction of being paid for a job done to say nothing of that intan

gible called human dignity the dole may be found a much too costly luxury for even a wealthy nation to afford

The ultimate objective of any remedial program should be to expedite the return of the unemployed to gainful employment In order that this end can be achieved the government has created a nation wide public employment service which operates in conjunction with the Social Security Board [15] This agency endeavors to bridge the gap between idle men and vacant jobs Since one of the obstacles in the way of the rapid assimilation of manpower into industry is labor s ignorance of where its services are in demand these employment bureaus by making job information available tend to minimize this difficulty Those workers who claim unemployment compensation under the Social Security Act or who are on W P A projects are required to register with their employment office These offices through careful investigation and job analysis determine the type of work which the registrant is competent to do When an opening in private business occurs a workman suited to the task is immediately informed of this opportunity If the workmen should refuse the job without good reason he is dropped from the files of the bureau [16]

The most efficiently operated labor exchange however can not solve the unemployment problem of everyone affected by a depression During the interim between the separation of the worker from his job and his reemployment it is necessary that he be provided for in some manner The government through the development of a public works program his striven to meet this exigency The principal agencies upon which the federal government has relied are the Public Works Administration The Works Progress Administration and the Civilian Conservation Corps [17]

(1) *The Public Works Administration*—The P W A s method of operating can best be illustrated by a case study Norwich Vermont by vote in town meeting elected to construct under the aegis of the P W A a town hall which was to cost approximately $50 000 Before the project was sanctioned by the regional office of the W P A the town was required to submit the architectural plans for the structure as well as prove its capacity to raise its share (55%) of the costs A local committee selected from many plans submitted that of the Wells Hudson and Granger Company of Hanover New Hampshire After various contractors had proffered their bids the contract for constructing the building went to W H

[15] The Wagner Peyser Act (1933) created a national system of employment offices by assisting in the establishment and maintenance through a system of grants in aid of state employment offices The present system continues the principle of state and municipal offices federally subsidized

[16] A fair job offer does not include any kind of strike breaking or wages hours or working conditions definitely below those prevailing in your community for the same kind of work A Robertson *The Government at Your Service* (Houghton Mifflin Company Boston 1939) p 95

[17] See Chapter 21 Government Expenditures for additional material

Trumbull contractor of Hanover New Hampshire The town in order to meet requisitions as they were presented secured a series of temporary loans at an average rate of 3½% from the Dartmouth National Bank The total amount of money thus borrowed was roughly $22 500 Subsequent to the completion of the project the interim loans were repaid to the Dartmouth National Bank out of the proceeds of a 20 year 2¼% bond issue floated through the First National Bank of Boston

Those men who were on relief and possessed the requisite skills were to have first claim against the jobs which were created Actually however the bulk of the workers employed on this project were the regular employees of the Trumbull Company This was owing chiefly to a scarcity in Norwich and its environs of the type of laborers needed The wages paid for the various tasks performed were those standard in the community for that type of work The company had the right to discharge anyone even though he originally had been drawn from the relief rolls if he proved incapable of doing the work This right was to insure efficiency of the labor force

The results of this expenditure were as follows the town of Norwich constructed a town hall which probably would not have been erected in the absence of federal aid the Trumbull Company received a construction contract of roughly $50 000 the architectural firm of Wells Hudson and Granger was employed to draft plans during a time when private construction was at a low ebb The Dartmouth National Bank as well as the First National Bank of Boston put money to work the companies making the materials going into the construction of buildings indirectly benefited from increased orders regular employees had an additional opportunity of continuing to be regular employees some of those on relief had an opportunity of once again earning incomes at a gainful pursuit and finally many local merchants benefited from the increased purchasing power that was made available to the community

This is but one example of P W A activity Its contribution to the problem of relief to the unemployed may better be grasped if it be recalled that this administration since 1935 has spent more than $5 billion and has been directly responsible for the employment of between 2 and 3 million relief workers

(2) *Works Progress Administration*—Mr F J after having been employed for some twenty years as an expert meat cutter by one of the chain grocery stores operating in New England was discharged in 1933 Soon his savings had vanished and such part time work as he did secure was inadequate to provide for the needs of his wife and two children In 1935 with his own funds depleted and the generosity of his friends worn thin he turned as a final resort to the W P A

Before he could become eligible for a W P A job however it was necessary to establish the fact of his need He presented himself to the

local welfare authority so that his poverty could be certified officially This municipal organization after investigating his case testified to his need for assistance His name was then turned over to the local employment bureau which placed it on file Subsequently when the W P A increased its personnel he was recommended and accepted The wage he received was $17 a week a sum which was estimated to be the amount necessary in Manchester N H to maintain a minimum standard of subsistence Later as provided in the law he was promoted because of his superior ability to the status of a supervisor which increased his monthly pay to $150

(3) *Some General Considerations*—Since the purpose of the work provided by the government is to tide the unemployed over the period of their involuntary idleness it is necessary that the scale of wages adopted does not act as an incentive for men to remain on government projects The government has met this problem by dropping men on relief work who refuse to accept private employment when offered During the period when men are in government employ high standards of performance should be insisted upon and all tasks should be made purposeful This would go far in preventing a feeling from developing that the work being done was of no consequence To a large degree the efficiency with which any project is conducted depends upon the competence of the project s administrator and the willingness of the locality to complain to Washington when in its opinion the work is unsatisfactory

(4) *Civilian Conservation Corps*—To meet the problems of those thousands of young men who caught in the vortex of the depression were being whirled about in confusion and despair the Civilian Conservation Corps was established Eligibility for enrollment requires that the applicant be a single unemployed person in good physical and mental condition In the selection of the candidates preference is granted first to those boys whose families are on relief or whose families are applying for relief then to those boys whose families while not on relief lived below a minimum standard set by the government The enrollee agrees to serve one full term of at least six months If during his period of enlistment he should be offered a bona fide job he is privileged to withdraw Pay is at the rate of $30 a month $22 of which is sent to the dependent members of his family

The members of the corps rise to the tune of a bugle at 6 o clock They dress make their beds clean up the barracks then report for roll call Breakfast is at seven thirty At eight o clock they leave for work returning at four In the evening if a member wishes he may attend classes which treat of both cultural and vocational subjects If he desires he may see a movie or call on a date At ten thirty lights are out

In addition to the advantages which accrue to the members society reaps its reward Roads are constructed forests are cleared of underbrush

reforestation programs are carried out dams are built soil is conserved and numerous other activities of a constructive nature are undertaken Society in thus protecting its youth against the ravages of unemployment also preserves its natural resources

(5) *Seasonal Unemployment and Remedial Action*—Remedial action is primarily a problem in management The forces making for seasonal unemployment are in varying degrees subject to human control Management however is no more able to halt the sun in its course than Canute the movement of the tides Nevertheless attempts may be made to influence consumers buying habits, to seek to supplement lines of merchandise or to strive to rearrange the productive program of a plant These endeavors possess this common virtue if they should prove successful seasonal unemployment would be minimized

It is difficult to think seriously about purchasing coal until there is a touch of fall in the air The buyer rather enjoys postponing filling his bins until there no longer remains a choice in the matter At the mine it may be the easier policy to lay men off during the slack season than to construct adequate storage space It is conceivable that the consumer could be persuaded to purchase his supply of coal earlier than has been his custom if he were offered the inducement of a price concession And if at the same time, the mines were to produce in anticipation of demand storing that part of the output not immediately needed it is probable that fewer men would spend what is now termed the slack months in idleness In the building trades a rainy day is becoming less and less a day of rest The attempt is made to arrange work so that inclement weather rather than turning men toward home turns them instead to inside tasks As the building industry improves its materials and perfects its techniques of construction it will grow less subject to the seasons The classic illustration of the mastery of seasonal unemployment is the experience of the Dennison Manufacturing Company This organization engaged in the production of paper products had its periods of intensive production and its periods of stagnation In order to smooth out this irregularity it expanded its line of merchandise so as to include goods that had peak markets during what were formerly slack seasons It also offered concessions to those who would place their orders far in advance of the date of delivery This permitted the company to use slack periods for the production of goods for stock The result of these changes was that the former irregular employment was replaced with continuous employment

One should not infer from a few notable achievements, however, that a solution to the problem of seasonal unemployment has been attained Many of the fluctuations making for seasonal unemployment are inherent in the modern industrial process In recognition of this fact the objective of a policy should be to minimize their influence when it is not possible to eliminate them directly It is a difficult task to change the habits of

people to say nothing of controlling the weather And as long as production in these seasonal industries is carried on under the existing rules of the game the employer will require a reservoir of unemployed from which to draw labor in times of peak production

(6) *Technological Innovations and Remedial Action*—Society s problem is to find a method by which it can retain the advantages which come with technological improvements and at the same time minimize the suffering of the displaced workers during the period of readjustment The dislocations wrought by new techniques are made less predictable and hence more difficult with which to cope because of the irregularity which characterizes the discovery of new methods and the uneven tempo at which they are put into use by industry Consistent development and steady assimilation of new machines by business has not typified technical progress in the past This tendency to concentrate the introduction of technological innovations in time periods of relatively short duration accentuates the frictional aspects of the problem of readjustment

If the rate at which machines were introduced was subject to control the displaced workers might possibly have a greater opportunity of being reemployed before their ranks were increased by additional batches of displaced workers This suggestion would not necessarily impede progress but it would replace a system of fits and starts with one of steady advance At the same time the nation wide system of labor exchanges would be assisting the men in their search for new employment opportunities Since technological improvements usually render skills worthless a retraining program equipping the worker with a new trade should be instituted Finally in order that the displaced worker can be assisted during his period of unemployment a dismissal wage based upon his weekly wage and his length of employment should be inaugurated This financial assistance would make the period of readjustment less of a tragedy for many men displaced by machines

(7) *Conclusion*—The only effective and economic method of providing protection against many of the risks to which laborers are heir is through a comprehensive system of social insurance When unemployment or old age removes a worker from the productive process neither should be permitted to interfere with his continuous receipt of a monetary income Unless he has some assurance that this assistance will be forthcoming the affected worker may not only become demoralized, but in his despondency contribute to the disorganization of his family and society Yet the sum which he receives should be his by right—by right of the fact that he has contributed to the creation of the fund upon which he now relies

CHAPTER 30

TOWARD SOCIAL SECURITY

Until the advent of the Social Security Act the misadventures of the destitute were ascribed at least among a large portion of the articulate to inherent defects in the character of these unfortunates Penury in old age and empty purses during unemployment were frequently explained as the penalties exacted of those who in their thriftlessness thoughtlessly disregarded their obligations to provide against the inevitable day of want The conviction that man with rare exceptions indeed could if he but chose personally provide against the numerous uncertainties which he was called upon to face was clung to most tenaciously Some went even so far as to view the granting of old age relief as tantamount to rewarding those who had failed in their duty to society That the individual affected may have had little if any control over his luckless destiny was not readily admitted by those who saw life as a boundless opportunity to improve one s fortunes As long as this pattern of thought underlay practice the lot of these hapless people was not an enviable one

The road that led over the hill to the poor house was the final route trodden by many of these indigent aged The conditions which were per mitted to exist in a majority of these almshouses and poor farms contradicted the professed respect in which Americans held their aged citizens [1] Inadequate and improper food filth and insanitary conditions characterized most of them Even in those institutions which were free of this form of negligence it was not uncommon for the feeble minded the diseased and the defectives to be herded together with the impoverished aged Those towns and counties which accepted the responsibility of caring for their impoverished often did so by stintingly doling out meagre sums to those who were willing to make a public profession of their pauperism An uninformed and indifferent public opinion set the tone of public relief, and the result was that such assistance as was extended was usually inade quate and customarily offered in a spirit of charitable condescension that was most humiliating to the recipient

It takes more than desire more than ingenuity, to save when an income is so small that necessities lay claim to it in its entirety [2] Even during the

[1] H C Evans *The American Poor Farm and Its Inmates* (Des Moines 1926)

[2] A Epstein *Insecurity—A Challenge to America* (Harrison Smith and Robert Haas New York 1933) Chaps 6 7 8 9 10 and 11 These chapters written before the passage of the Social Security Act defend the proposition that in the absence of social insurance the average workman is incapable of providing against want in old age or misery during unemployment

1920s when the country was full to bursting with prosperity the income of the average industrial worker was insufficient to supply the everyday needs of his family and still yield a surplus which could be set aside for the inescapable days of want To ask the worker to provide unassisted against the contingencies he will be called upon to face is asking him to do the impossible Even though pennies were pinched until their shapes were distorted there were too many workers with too few pennies to make penny pinching an effective solution of the problem

What was required was the will first to recognize that an Elizabethan technique despite its respected ancestry was an anachronism in an industrial society and second to admit the necessity of substituting enlightened social for individual responsibility for the care of the indigent aged and the impoverished unemployed

Company Benefit Plans

A factor which militated against a ready acceptance of a program of social insurance was the belief held by some especially prior to the depression that the company pension plans which were then in vogue would adequately provide for the worker during his declining years Several hundred of the most important companies in the United States had in a modest way begun voluntarily about 1875 to institute pension systems for their employees It was the purpose of these schemes to provide for the employee when he became superannuated or permanently disabled It was the hope that with time these systems would be extended to cover an ever widening group of workmen in an ever increasing number of industries in an ever more adequate fashion

There is a tendency to explain the reasons which motivated businesses in this instance by some sweeping generalization To accuse all those companies which instituted these programs of being actuated purely by narrow selfishness is doing a great disservice to many individual firms Among some employers there was a genuine desire to free the worker from the dreaded fear of superannuation by assuring him a continued income Among others the retirement program offered an effective means of clearing the working force of elderly workers without arousing resentment against the company Still others saw in the program a means of resisting unionism An employee with the promise of a pension may develop a deep sense of loyalty to his employer or the pension payment may be contingent upon the worker s refusal to join a union or engage in a strike Just which of these reasons was uppermost in the mind of any given employer may be difficult to determine some or all of them may have played a part And what is more the reason which may account for the initial acceptance of a retirement program may not subsequently be the reason for its retention

Despite the high hopes that some held for company benefit plans they

failed of expectation The Social Security Board in a study under the direction of Dr F E Witte came to the following conclusions concerning these plans

The half century of experience with voluntary pension plans has shown that they have been inefficient and inadequate as sound social insurance measures The proportion of all employees in the field affected has been small never rising above 15% Even within the field which these voluntary pension systems embrace the terms of the plans are restricted so that relatively few employees qualify for pensions It has been estimated that in 1927 the number of pensioners did not exceed 90 000 and that the total annual pension payments were not more than $55 000 000 An estimate from the same source for 1931 was that pensioners did not exceed 140 000 at the end of that year and that pension payments aggregated no more than $97 000 000

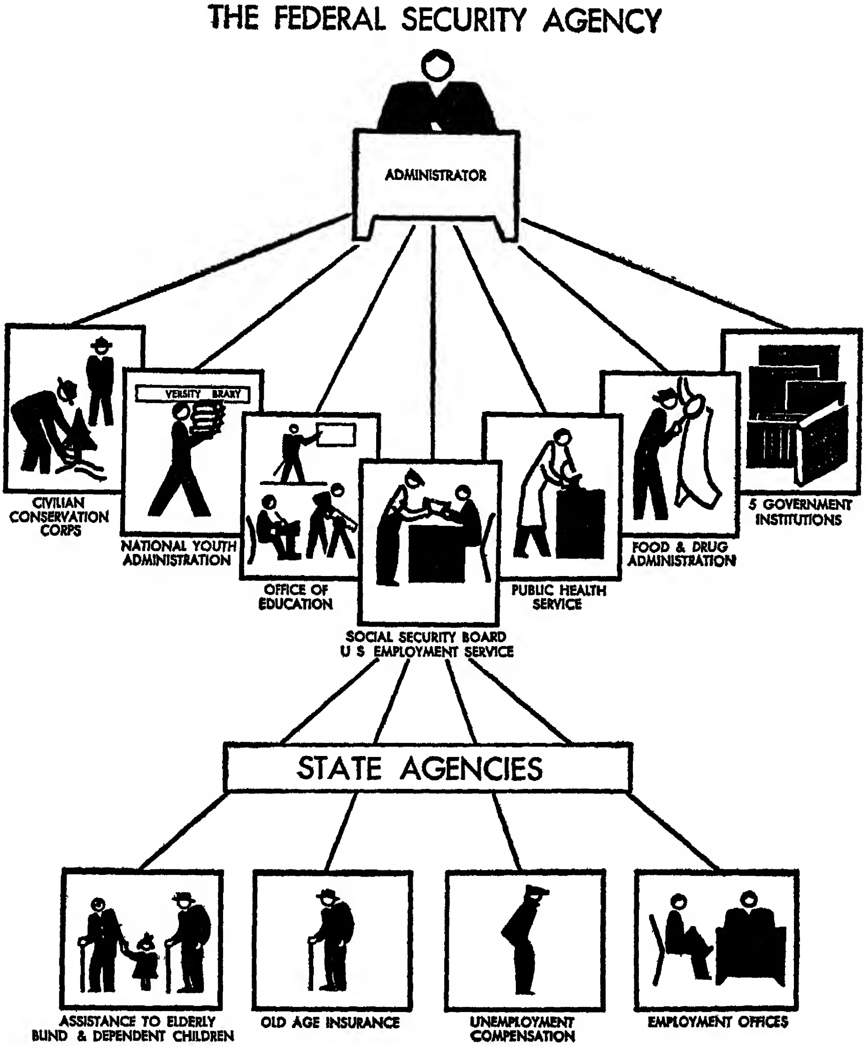
Moreover these voluntary plans contain many elements of discrimination In most cases at least until recent years the benefits have been related to the pay of the final few years of service While this has protected all employees to a certain extent against the hazards of changes in the price level it has nevertheless produced pensions which were much larger in proportion to the total value of the services rendered for executives and supervisory employees than for the rank and file Moreover the continuous service requirements have discriminated against low salaried employees as compared with those in official and executive positions [8]

As large as were the funds ($800 000 000) set aside in 1935 by business to meet its liabilities under its pension provisions they were probably far from sufficient It was estimated that as early as 1928 total liabilities for pensions were as much as $2 200 000 000 and since that time the liabilities have increased and this despite the shrinkage in employment At the beginning of 1935 there were about 175 companies employing normally in excess of 2 000 000 workers which made no guaranty whatever of awarding pensions or of continuing the annuity payments once the pensions were granted

Regardless of the high purpose and good intentions of those who initiated these pension systems they viewed as a means of providing security to the industrial worker in his old age are wholly inadequate A program to be effective must be much wider in its coverage than are the company pension systems and furthermore it must be free of the restrictions imposed by the continuous employment provision as well as being actuarially sound

[8] The Social Security Board *Social Security in America* (Washington D C 1937) pp 176 178 The continuous service requirement is that provision commonly found in these programs which makes a worker eligible only if he has been in the employ of the company some 20 to 25 years.

ADMINISTERING THE SOCIAL SECURITY PROGRAM



[Pictograph Corporation]

Social Security Act

Introduction—In response to the growing demand for relief from the specter of want created by old age and unemployment the President of the United States on June 8 1934 appointed the Committee on Economic Security[4] The depression which had intensified all the worst aspects of unemployment and aged poverty also swelled the ranks of those economic messiahs who moved through the land offering their panaceas to all who would come and partake That their nostrums had the therapeutic quality of a horse chestnut was of lesser importance to those in want than that some one seemed to be interested in their plight They listened and they believed because believing was all that was left to many of them Congress could not long close its collective ears to this thunder from the left These aged united into a potent political force were insisting with increasing determination that the program of the good Dr Townsend be adopted Acting upon the report of the Committee on Economic Security and responsive to the increasing clamor from home the Congress voted the Social Security Act which became law when the President on August 14 1935 duly affixed his signature

The act[5] provides for a federally administered and federally financed system of old age pensions and survivors insurance The states are offered federal cooperation and financial assistance in setting up their own programs of unemployment insurance aid to needy aged the needy blind and dependent children services for maternal and child health child welfare the treatment of crippled children public health and vocational rehabilitation

The original law was amended in 1939 The major changes which were introduced were the old age insurance program was broadened so as to provide earlier and more liberal payments of benefits monthly benefits are no longer restricted to the worker but are extended to his family as well increased federal grants for public assistance and for health and welfare services were provided and changes in the taxing provisions relating to the old age and survivors insurance and unemployment compensation were enacted By extending the coverage of the act to occupations and industries not formerly included an additional 1 100 000 workers are brought within the provisions of the act Approximately 45 700 000 accounts have been established for workers and about 35 000 000 of these workers have wages already credited to their accounts

[4] This committee consisted of the Secretary of the Treasury the Attorney General the Secretary of Agriculture the Relief Administrator and the Secretary of Labor the last named serving as chairwoman

[5] The act as presented herein includes the amendments of August 1939

Old Age and Survivors Insurance

First it should be noted that this is a federally administered and fed erally financed program which is nationwide in its operation The benefits which accrue to the workers under the provisions of this section of the Social Security Act come to them as a *right* and not as a governmental concession The federal old age and survivors insurance program is de signed to prevent destitution among the aged in the low income group It is a preventive measure which aims to reduce the extent of future dependency among the aged Furthermore it is hoped that as time pro gresses there will be a lessened need for state old age assistance as more aged people find it possible to meet their needs from their pensions

(1) *Eligibility*—A worker to be eligible for an annuity must fulfill cer tains conditions prescribed in the Social Security Act First he must have been employed in a *covered* industry for a specific period of time second he must have earned a designated amount of pay during his employment in a covered industry third he must be 65 years of age or over before applying for his annuity and finally he must give up gainful employ ment [6]

The law does not cover all workers but only those in the so called *covered* industries In general employment in agriculture in domestic service in charitable educational or certain other non profit making organizations is not employment in a covered industry self employed persons and housewives are not covered The exclusion of these occupations from the provisions of the act limits the benefits roughly to slightly more than 50% of the gainfully employed Furthermore it is required that wages of at least $50 must have been received in each of a certain designated number of calendar quarters from work performed in a covered industry A calen dar quarter is defined by law as the subsequent three months span in any year beginning with the first of January April July or October Those quarters in which the minimum sum has been earned are termed quarters of coverage [7] It is necessary that this minimum amount be earned in at least one half of the quarters which elapse between 1936 and the time when the applicant reaches the age of 65 If he should have reached 65 prior to July 1 1940 six quarters of coverage are all that is required thus easing the requirements

(2) *The Benefit Payment*—The amount of the monthly annuity received by the beneficiary is based upon the *average* wage earned by the applicant

[6] An applicant is not considered to be gainfully employed if he earns less than $15 a month in a covered industry or if he is employed in a non covered industry

[7] The law until amended in 1939 did not include in computing one s earnings any amount earned by the applicant after he had reached 65 This provision has since been changed However since the amendment did not become effective until 1939 the years interven ing between the time of the original adoption of the act and 1939 are not included if the person had reached 65 by the time the law originally went into effect

in the covered industries in which he has been employed [8] The rule applica ble to the vast majority of workers operates in this manner The worker when applying for his annuity sums up the wages which he has received while employed in a covered industry between the time the law went into effect (January 1 1937) and the beginning of the quarter in which he qualifies for the benefit In computing this amount that part of an annual wage which exceeds $3 000 is not included The aggregate thus obtained is then divided by the number of months which comprise this period The resulting amount constitutes the average monthly wage

Example [9] Suppose a man were 55 years old in 1937 and expected to retire in February 1947 All his pay from jobs covered by the law counting from January 1 1937 to the beginning of the quarter in which he retires—that is until January 1 1947—are added together and divided by the number of the months in those ten years which is 120 If he had been earning $1200 each year his total wages would be $12 000 Dividing this $12 000 by 120 gives an aver age monthly wage of $100 If he had been paid by the piece so that he earned different amounts each week or month they would be added up in the same manner and the total might be an odd figure—for example $13 456 47 Dividing that total by 120 would give an average monthly wage of $112 14

There is a special rule which applies to those workers who reached 65 before 1939 Since such workers are now eligible for annuities it was necessary to devise a technique for ascertaining their monthly benefit The method used is as follows If the worker had reached 65 before the law went into effect his benefit will be determined on the basis of his average monthly pay figured from the first of January 1939

Example Suppose a worker were 65 years old before January 1, 1937 when the law went into effect and is still at work on a job that is covered by the law If he retires on January 1 1941 the amount of his benefit will be figured on his average monthly pay from January 1 1939 If his total pay from January 1 1939 to January 1 1941 is $2880 this is divided by 24 the number of months in the two year period This would give an average monthly wage of $120

After the average monthly wage is computed, it is then broken into a series of increments On the first increment of $50 a sum is figured at the rate of 40% On the increment that remains an amount is computed at the rate of 10% These two sums are then added together Then, 1% is taken of the total just computed for each year in which the worker has earned $200 or more in a covered industry This amount is added to the former total giving the monthly benefit which accrues to the applicant No benefit however will be less than $10 a month even though upon the bases of the calculations it should be

[8] Under the original law the amount of the monthly benefit was determined on the basis of *total* wages received by the applicant in covered industries

[9] The examples herein used are taken from How to Calculate Benefits under the Federal Old age and Survivors Insurance Social Board Washington D C 1940

Example Suppose a worker s average pay is $100 a month and by the time he is ready to claim the benefit—say in 1957—he has been getting that much continuously for 20 years To find his monthly benefit payment take 40% of the first $50 of the $100 plus 10% of the remaining $50—that is $20 plus $5 Then add 1% of that $25 for each of the 20 years That makes another $5 Adding this to the $25 makes a total of $30 a month This would be his primary insurance benefit which he would receive each month after age 65 for the rest of his life

(3) *Family Benefits* —Not only does the amended old age insurance program assure to the eligible worker a monthly annuity upon reaching 65 but the protection afforded by the act is extended to his family If the wife of a beneficiary should be 65 she is entitled to a supplementary benefit equal to one half of her husband s monthly pension If it should so happen that there is a dependent child under 16 years of age or under 18 if still attending school he too is eligible to a separate benefit equal to one half of the father s benefit

Example If the worker is married and his wife is 65 years of age or over she will receive a monthly payment equal to one half that of her husband If his primary benefit is $30 a month the wife will receive $15 a month also making a total of $45 a month for the two as long as both of them live

If however the wife had worked for pay and had earned benefits of her own amounting say to $25 a month she would receive her $25 instead of the $15

If the worker has dependent children and if his primary benefit is $30 each child will receive one half that amount or $15 a month until he is 16 years of age

If an insured worker should die and leave a widow who is over 65 she is entitled to a benefit equal to three fourths of her husband s annuity If she should be less than 65 yet has dependent children in her care she receives a similar benefit If the deceased should be survived by a dependent child under 16 he would receive a benefit equal to one half of the father s annuity If the wage earner leaves no widow or dependent children but does leave a parent over 65 who was wholly dependent on him then the parent receives one half of the worker s annuity

Example Suppose a worker dies leaving a widow and two dependent children Assuming his monthly benefit payment to be $27 50 his widow s benefit would be three quarters of that or $20 63 In addition there would be one half of the worker's benefit or $13 75 for each child making a total of $48 13 for the family until the first child reaches 16 years of age

As the children grow up their benefits stop and finally when they are all over 18 the widow s benefit is discontinued until she is 65 If she does not marry again she may receive a monthly payment of three quarters of her husband s benefit in this case $20 63 for the rest of her life after 65

If the worker should leave no survivors qualified for the monthly benefits at the time of his death a lump sum equal to six times his monthly benefit may be paid to a widow a widower or certain other relatives or if there should be no such relatives the person defraying the funeral expenses will be reimbursed up to an amount equal to six times the worker s benefit

Example If the monthly benefit were $30 and the burial costs were $150 the lump sum payment would be $150 If on the contrary the burial expenses were $200 the lump sum payment would be $180 or six times the worker s monthly benefit

(4) *Financing Old Age and Survivors Insurance*[10]—In order that the costs incident to this program can be defrayed both the employer and the employee in the covered industries are subjected to a tax The tax is based upon the wages which accrue to the worker excluding that part of an annual wage which is in excess of $3,000 The rates of the two taxes are as follows

Period	*Percentage Payments on Wages and Salaries in Covered Industries under $3 000 a Year*	
	Employer	*Employee*
Through 1942	1 0	1 0
1943 1946	2 0	2 0
1946 1949	2 5	2 5
Thereafter	3 0	3 0

Every three months the employer is compelled by law to pay into the federal treasury the taxes for both himself and his employees The employer recoups the taxes he pays for his employees by deducting the sums from their salaries Whether the employer can recoup his contribution by passing his tax on to the consumer in the form of higher prices is still a matter of conjecture However if it be assumed that part at least of the tax is so shifted the enhanced prices may be viewed as society s contribution to the support of the program The return which is made by the employer shows the name and the social security account number of each employee and the amount of wages paid him during the last quarter

The taxes which are paid flow into the general fund of the treasury Congress then appropriates to the old age and survivors insurance trust fund an amount equal to the taxes which have been collected The trust fund is under the management of a Board of Trustees which is made up of the Secretary of the Treasury who acts as the Managing Trustee the Secretary of Labor and the Chairman of the Social Security Board The Board of Trustees reports on its stewardship to Congress at stated intervals

That part of the funds which is not required to meet current with

[10] See the chapter entitled Taxation and Social Control

drawals that is the payment of old age and survivors insurance benefits and the administrative costs of the program must be invested by the Managing Trustee in interest bearing obligations of the United States or in obligations guaranteed as to principal and interest by the United States

Old Age Assistance

(1) *Introduction*—Unfortunately there are many aged people who will not qualify for an old age insurance benefit Some may have already reached the age when employment is no longer to be had and such resources as they do possess are insufficient to provide for their needs Others may have spent their years of gainful employment in a non covered industry A portion of those who do establish their eligibility may receive so small a benefit ($10 a month) that unless a supplementary grant is made to them they too will be in want It is the purpose of the old age assistance program to meet these contingencies The ideal which is striven for is that these two programs—old age insurance and old age assistance—working jointly will banish from the land destitution among the aged The great hope is that America will be a country in which men will approach their declining years with a comforting sense of security

Unlike the federal system of annuities in which the benefit comes to the recipient as a right the financial aid extended to the aged under the old age assistance program is granted as a concession The monthly assistance checks are *not* paid from a fund which the receiver through some systematic scheme of savings has created but are paid by the state from its general tax receipts or from the receipts of a tax specifically levied for this purpose It should be noted too that this is not a federal program as is the insurance scheme The states not the federal government determine how much and to whom the aid shall be given The federal government does however participate in the operation of the program It assists the states in defraying the costs entailed by the assistance program The federal government s participation is not limited to its financial contribution alone but it also sets a general pattern of performance to which the states must adhere if they are to receive federal financial assistance This pattern has been developed with an eye to retaining those aspects of already established state old age assistance programs which have proved practicable while at the same time discarding those features which have proved undesirable

(2) *Administration of Federal State Plans*—The Social Security Board is the federal agency authorized to administer the old age assistance provisions of the Social Security Act To qualify for a federal grant a state must have its plan approved by this board The board notifies the Secretary of the Treasury of those states whose plans have been certified and indicates the amount of the grant to which they are entitled

Although the actual administration of the plan resides with the state

the federal law specifies (1) that the plan must be state wide in operation (2) that a single state agency must be established or designated either to administer the plan or to supervise the administration if such administration is delegated to political subdivisions of the state (3) that the plan must be mandatory upon all subdivisions of the state if administered by them (4) that the plan shall provide such methods of administration as are found by the Social Security Board to be necessary for the efficient administration of the plan (5) that the state agency shall make reports to the Social Security Board from time to time furnishing such information as the board may deem necessary (6) that the plan must provide for granting to an individual whose claim for old age assistance is denied an opportunity for a fair hearing before the state agency (7) that the plan must provide for the payment to the United States of one half of any amount which the state or its political sub division may claim of the estate left by a decedent assistance receiver [11]

(3) *Eligibility*—To establish his eligibility the applicant must not be under 65 years of age and *he must be in need* The determination of what set of circumstances constitutes a condition of need rests with the individual states By permitting this decision to be made by each separate state the old age assistance program continues in some states both to smack of charity and to retain some of the stigma associated with the old poor laws Need is at times held to be synonymous with destitution The failure of the federal government to define need with greater precision has opened the way to numerous and varied interpretations of the terms In many states citizenship is a prerequisite The federal government insists how ever that if this requirement is met by the applicant the state if it wishes to receive federal financial assistance cannot rule the applicant ineligible for any reason connected with his citizenship For example he cannot be held ineligible because he hasn t been a citizen long enough or because he happens to be a citizen whose skin is of a particular pigmentation Ordinarily the states establish a five year resident requirement Usually it is mandatory upon the applicant that he shall have lived within the state a full year before making application and for four other years within the nine year span preceding the year in which his request is filed A state is forbidden to compel a longer residence period than this And what is more a person cannot be refused assistance on the grounds that although he has fulfilled the residence requirement in so far as the state is concerned, he has not lived sufficiently long in some particular town or county In short the program is to be state wide in its operation

(4) *The Pension Payment*—The amount of the monthly payment which is granted to the needy aged is a matter decided by each state itself Assuming that the Social Security Board has certified the state's plan the federal government will through a system of grants in aid, match the

[11] Social Security Board *Social Security in America* (Washington D C 1937) p 218

contribution made by the state up to a maximum of $20 Thus if the state were willing to contribute out of its own resources $20 the federal government would pay an additional $20 yielding the recipient a monthly total of $40 The federal government will not however extend this assistance if the state should maintain its needy aged in public institutions It is the object of this restriction imposed by the national government to induce the states to set up their pension system in a manner that will make it possible for these aged beneficiaries to spend their last years in familiar surroundings There is nothing in the law which prevents a state from paying a pension which exceeds $40 a month If this should be done the excess must be paid by the state For example assume that a state should establish a pension of $50 a month the federal government would contribute $20 the maximum permitted it and the state $30 On the contrary if the pension were but $12 a month both the federal and the state governments would contribute $6 each In addition to this grant in aid the federal government advanced as a gift to the state an additional amount equal to 5% of the state s pension payments This sum is to assist the states in defraying the administrative costs incident to the carrying out of an old age assistance program

The receipt of a federal annuity does not *necessarily* exclude the recipient from also benefiting under the old age assistance program If the state should hold an annuity to be insufficient to maintain a minimum standard of comfort it may if it should so elect supplement this sum by an additional grant made under the aegis of its old age assistance plan This is but a possibility however the meagre size of the pensions which are at present ordinarily allotted by the states does not make it appear that this possibility is likely to occur within any reasonable future time

Unfortunately the national government failed to set a minimum pension which states must pay to qualify for federal financial assistance Despite the generosity of some few states this failure to create a floor below which a 'pension would not be permitted to fall has resulted in "pensions' of distressingly small size being granted by many states

(5) *Financing the Old Age Assistance Plan*—Unlike the federal system of old age insurance the old age assistance programs of the various states do not rely upon any single specific tax to secure the funds necessary to defray the costs of these plans Each state can raise the needed revenues from any tax or any combination of taxes which it may elect to use As a result there is no uniform tax scheme to which all states adhere each relies upon that revenue method which to it appears most feasible in light of its particular social economic and political situation The program may be financed out of general state funds If this is done the existing system of taxation is called upon to raise additional revenues On the other hand a sales tax or a poll tax may be instituted New Jersey unlike the other states turned to the inheritance tax

In so far as the federal contributions to the states are concerned all that can be said and that is little enough concerning their source is that since they are paid from the general fund of the treasury they come from what ever taxes the national government is at the time using

This divergence in practice makes any generalization purporting to place the burden for the support of old age assistance on any specific group rather meaningless The only purposeful method which could yield even an approximately correct answer to the query of who pays for this program would be that which made a separate study of each individual state And even this technique would fail to account for the burden imposed by the federal contributions Naturally however a state which relies exclusively upon a poll tax would distribute the burden quite differently from one which depended primarily upon an inheritance or an income tax Too since taxes differ as to productivity the size of the pension depends, *in part* upon the tax or group of taxes which the state utilizes

Unemployment Compensation

(1) *Introduction*—All states the District of Columbia Alaska and Hawaii have unemployment compensation laws and are paying weekly benefits to insured wage earners who have become temporarily unemployed [12] In each state a public employment service connected with the state unemployment compensation system registers unemployed workers both insured and non insured and tries to help them find suitable jobs This dual service—job placement and job insurance—is the employment security program part of the national Social Security program This is a cooperative federal state program Each state administers its own employment security program in accordance with certain general standards laid down by the federal government In general the employment security plan is designed *to help the worker to find a job* or, if no job is immediately to be had to provide him with sufficient money to live on until he does find one

(2) *Federal Participation*—The Social Security Act does *not* set up a federal unemployment insurance system nor for that matter does it set up any unemployment insurance system at all What it does do however is to make it possible for the federal government to encourage the individual states to establish unemployment insurance programs This end is achieved by granting to those employers liable to the special tax upon payrolls a credit offset against this tax if they participate in a mandatory state system of unemployment insurance and by providing that the federal government shall pay the full administrative costs of such state unemployment insurance programs as are approved by the Social Security Board Too state employment services which are operating under the Wagner Peyser act receive additional federal grants to enable them to expand their job placement activities for workers receiving unemployment benefits

[12] Social Security Board *Unemployment Compensation* (Washington D C 1940)

The federal payroll tax as the name implies is levied upon the payrolls of all employers other than those to be immediately noted who employ eight or more persons In computing the amount of the payroll only the first $3 000 a year actually paid to an employee is included [13] The rate of the tax is 3% The employers of the following types of laborers are not subject to the payroll tax

1 Agricultural labor
2 Domestic service in a private home
3 Service for one s husband or wife or by a child under 21 for his parents
4 Maritime service
5 Service for the federal or a state government or their instrumentalities or subdivisions and
6 Service for a non profit religious charitable scientific literary educational or humane organization [14]

The law permits the employer to take as a credit offset against his federal payroll tax the contribution which he makes to his state unemployment insurance system provided that this credit offset does not exceed 90% of his federal payroll tax liability For example if the state were to levy an unemployment insurance tax at the rate of 2 7% of the employer s payroll this entire amount could be credited The employer would then pay the 2 7% (90% of 3%) to the state and send the remaining 3% to the federal government What this means in practice is that 90% of the federal tax is automatically transferred to the state treasury assuming of course that the state program has been approved by the Social Security Board

This method of credit offsets originally used to induce the individual states to accept death duties met one objection that had frequently been raised against state systems of unemployment insurance It had been claimed by employers in those states which had enacted or contemplated enacting unemployment insurance programs prior to the advent of the federal payroll tax that they were placed or would be placed in a most disadvantageous competitive position Those businesses which offered their goods in a nation wide market had to bear an additional cost—unemployment insurance taxes—which their competitors in those states not having unemployment insurance compensation escaped The federal government by imposing the payroll tax and incorporating in the legislation the credit offset device answered this objection by equalizing the position of these competitors

The employer can receive credit against the federal tax only if the state

[13] Until the law was amended in 1939 the act provided for the levying of a tax on the employer s entire payroll It is estimated that by this amendment employers will save about $65 000 000 a year

[14] It is estimated that despite these exclusions there are some 28 800 000 workers who are now covered by state programs

law is approved by the Federal Security Board In order to secure such approval the state law must provide that

(1) Compensation is to be paid solely through public employment offices in the state or such agencies as the Social Security Board may approve
(2) No state pays out benefits until two years after the date on which the assessment of contributions is made under the state law
(3) All money received in the unemployment fund shall immediately upon such receipt be paid over to the Secretary of the Treasury to the credit of the unemployment trust fund
(4) All monies withdrawn from the unemployment trust fund by the state agency shall be used solely in the payment of compensation exclusive of expenses of administration
(5) Compensation shall not be denied in such state to any otherwise eligible individual for refusing to accept new work under any of the following conditions
    a if the position offered is vacant due directly to a strike lockout or other labor dispute,
    b if the wages hours or other conditions of the work offered are substantially less favorable to the individual than those prevailing for similar work in the locality
    c if as a condition of being employed the individual would be required to join a company union or to resign or refrain from joining any bona fide labor organization

These requirements are considered to be the minimum that will insure that the state law is a bona fide unemployment compensation law and that the investment objectives of the federal act are secure

The Social Security act furthermore requires that the unemployment compensation funds controlled by and belonging to the individual states be deposited with the United States treasury The Secretary acts in the capacity of the trustee of these funds The respective state agencies which administer the various unemployment compensation programs are the beneficiaries of the trust Although the individual contributions of the various states are pooled for purposes of investment it is obligatory upon the Secretary of the Treasury to maintain separate accounts for each state This fund by law must be invested in the direct obligations of the United States or securities which are guaranteed as to principal and interest by the national government When requested by the proper state agency, it is mandatory upon the Secretary of the Treasury to pay from the funds credited to a particular state the amount needed by it for the payment of unemployment compensation The reasons for establishing this particular method for handling these monies are two first the need to assure the safe custody of unemployment compensation reserves second to so control the investment and liquidation of these funds that industrial stability will not be jeopardized

(3) *State Unemployment Systems* —The Social Security act leaves to the individual state the decision as to whether it will or will not initiate an unemployment compensation program If the state should elect to institute a system wide latitude with regard to the type of program it will establish is permitted it Except for the necessity of abiding by the minimum requirements formulated by the national government the states are free to set up any unemployment compensation plan they may wish The state may if it so chooses require that contributions be made by employees as well as employers The states too are left to determine their own compensation rates the length of the waiting period and the maximum duration for which the benefits will be paid This latitude has been granted in recognition of the wide variations which exist in the social and economic make up of the individual states and particularly because of the wide variations which mark the rate of unemployment in the separate states

Despite the differences in minor details which exist in the practices of the various individual states unemployment compensation systems are basically of two types the pooled fund form and the employers reserve type Under the pooled fund form which incidentally is the most commonly used type the unemployment compensation contributions are accumulated in a single general fund and it is from this fund that the benefits are paid By implication the theory underlying the pooled fund technique does not assume that the individual employer is responsible for unemployment nor that he alone has any significant control over its volume rather it assumes unemployment to be a concomitant of modern industrialism, and as such can best be met by spreading the risk and the costs over as large a group of employers as possible The employers reserve system sometimes referred to as the American system rests on the assumption that unemployment can be greatly lessened if the contributions of the individual employer, or a closely associated group of employers are determined on the basis of the employment experience of his or their particular group of workmen Under this scheme the financing of the program would be borne entirely by the employer and his contributions rather than flowing into a general fund would be segregated into a number of individual employer's funds If he should succeed in stabilizing employment within his plant and after he has accumulated a reserve fund of some predetermined minimum size, his contributions would then either be scaled down or discontinued

It is argued by the proponents of the employer reserve method that not only does it possess the psychological advantage of making the employer s contribution a function of the regularity of employment within his plant but this relationship itself tends to keep constantly before him the necessity of bending every effort to stabilize his production In the absence of this incentive it is maintained that the employer may follow the easier path of discharging his employees when business slackens knowing that

in any event they will be provided for out of the common fund rather than endeavoring to maintain employment in the face of a depression by reducing hours or spreading work or rationalizing his plant

The opponents of this method question whether the financial savings are of sufficient size, when compared to the other costs which the employer must meet in the normal course of his business to be of strategic significance If greater regularization of employment is economically advantageous to the employer he would strive for it regardless of the type of unemployment compensation plan in operation Too since some industries partially because of their inherent natures have a higher incidence of unemployment than do others the employees of such industries would be penalized if unemployed The benefits which they can receive can be paid only from their own employer s segregated fund and since it is the type of business in which lay offs are frequent the fund is apt to be of meager size The benefits actually paid would probably be insufficient to insure an adequate or continuous income The object of unemployment compensation is by pooling the risks, to provide protection against unemployment not for this or that particular group of men but for all employees, irrespective of their employers

(4) *Merit Rating*—Merit rating is that technique which determines an employer s unemployment tax liability by comparing the unemployment benefits which have been paid to his employees with the unemployment taxes which he has paid in the past This practice is common in many (35) of the states which operate under the pooled fund system Thus if an employer has had so small an amount of unemployment that the benefits paid his employees constitute but an insignificant fraction of the taxes which he has paid into the pool he is granted a reduction in his subsequent unemployment tax contributions This like the employer reserve system, aims to minimize unemployment by offering an incentive to the employer to stabilize his working force

This system has been subjected to several criticisms The employer s merit rating is in fact not dependent exclusively upon his ability to stabilize employment within his own plant but in part upon the ability of the men he may lay off to find new jobs within a relatively short period of time Since most state laws do not pay benefits until the worker has been without a job for two or three weeks if employment should be found within that period, the status of the employer would not be adversely affected It is conceivable therefore that the merit rating of an employer may be the result not of anything over which he has control but of the luck which attends the worker in his quest for a new job Too the theory of merit rating seems to assume that unemployment is basically a result of the actions of individual business men functioning as separate entities Thus it appears that the theory fails to give due weight to the influence of swings in the business cycle of the introduction of technological inno

vations of seasonal variations in demand and production upon the volume of unemployment Finally if the cost of unemployment is to be spread as equitably as possible over the group as a whole the ability to bear taxes rather than the past employment experience of any single employer would appear a more reasonable and acceptable basis for the distribution of the tax burden involved

(5) *Eligibility*—The purpose of unemployment compensation is to provide benefits to those workers who though customarily employed are *temporarily* without jobs It is not the function of this program to provide for unemployables In order for the worker to establish his eligibility for a benefit he must prove that he has worked some specific period of time and usually that he has earned some definite amount of wages The exact amount of work or wages which is necessary to qualify him differs as between the various states Under most of the state laws the sum of wages which must be earned is expressed as a certain number of times the weekly benefit to which he is entitled or as a flat sum of wages say $100 or $200 Too, he ordinarily must be engaged in one of the industries which is subject to the federal pay roll tax although this is not mandatory upon the state It can if it should so elect extend the coverage to other industries

To be eligible the affected worker must file a claim at a public employment office while at the same time register for work The purpose of this provision is to assist the unemployed person to find a new job This is in harmony with the dual purpose of the act—unemployment compensation and a reemployment service

(6) *Benefits*—Benefits are paid only to those workers who are willing and able to work but cannot find employment After the worker has registered at the employment office there is a waiting period before his unemployment compensation benefits begin In most states this period is of two or three weeks duration It is hoped that the worker s own resources will be sufficient to carry him through this period too it is hoped that during this interval a new job may be found for him

The weekly benefit paid in most of the states amounts approximately to one half of the worker s regular weekly wage so long as this amount does not exceed $15 A few states somewhat more generous offer benefits of $16 and $18 Under some state laws these benefits will be paid for a definite period of three or four months provided the worker remains unemployed for that length of time In other states the period is ascertained by computing the wages which the worker has earned or the number of weeks which he has worked during the year or two preceding his loss of his job Each week of employment and/or each sum of wages establishes a benefit credit to his account He when unemployed then receives compensation until he has exhausted the credits which he has accumulated or until he has received the maximum benefits permitted by the state law

In all but six states a worker is not eligible for benefits if he is out of

work because of a strike which is in progress in his place of employment All the states with one exception provide that if an employee should of his own free will and without good reason quit his job his waiting period will be extended If a worker should refuse a suitable job his benefits in some states would cease in other states his waiting period would be greatly extended However in determining what constitutes a suitable job the state is guided by the provisions laid down in the Social Security act

(7) *Financing State Unemployment Compensation*—In every state those employers who come under the unemployment compensation laws are required to make regular contribution to a state fund Ordinarily the rate of this tax is 2 7% of the wages paid by the employer although in some few states the rate is slightly higher In only five states are employees also required to pay contributions The relation of the federal tax to the state tax as well as the custody of these funds has already been discussed Whether the employer bears this tax or shifts it to consumers in the form of higher prices or backward to employees in the form of lower wages is debatable However it would appear that when this tax plus the tax for old age assistance are considered together it is questionable whether they can be entirely shifted by the employer

Toward Social Security

The Social Security act is not the perfect nor the complete solution to the problem of insecurity It is but a step albeit a most significant and lengthy step toward the desired goal It is one of the most important pieces of social legislation ever enacted by the federal government The act though greatly improved by the amendments of 1939 still contains weaknesses inadequacies and contradictions Yet if the law as it now stands should be thought of not as the triumphal culmination of a prolonged struggle to achieve social security but as a growing developing thing which shall be improved constantly ultimately the law will be brought into closer harmony with the ideal sought

One object which should be striven for is an extension in the coverage of both the old age and the unemployment insurance programs There are still millions beyond the pale Destitution in old age and want during unemployment rest no more lightly upon the shoulders of these weary people than upon those in the covered group Social security must seek to protect not some specific group against the hazards of inadequate income but all who are the victims of this unfortunate situation

The states should be prohibited from paying benefits of such meagre size that they are inadequate to maintain a minimum standard of living This would require to be successful more than a negative prohibition enforced by the federal government although such minimum requirement legislation in itself would be helpful Federal aid in greater amounts should be granted the states States do vary some are wealthy some are

poor some have a high incidence of unemployment others escape lightly some have a high percentage of impoverished elderly people others comparatively few Those states which are poor regardless of what their wish may be may find it financially impossible because of their limited resources to do more than allot miserly sums as benefits If the federal government should increase its grants and if greater latitude were given the administrative board in apportioning these funds among the states the poorer members of the family of states could through the receipt of more adequate subventions more generously provide for their citizens

It is contradictory to claim on the one hand that the old age insurance annuities come to a man as a right as a return upon funds which he has accumulated and on the other to insist that he give up gainful employment in order to establish his eligibility for these benefits If they are his they should be his whether he continues to work or not This provision is a concession to those who believe that the retirement of the aged is necessary to provide work for the young

It is questionable whether it is wise social policy to have the financial burden of this program rest principally if not exclusively upon workers and consumers They are the least able to carry additional burdens It would be sounder if the general tax structure of the federal government were tied in more thoroughly with the other taxes being used Probably a program so financed could better withstand the severe shocks induced by depressions Too under the existing law younger workers pay larger sums than their risks warrant in order that older workers can receive benefits greater than their contributions justify If the general tax structure were to contribute more to the program than it does this inequity could be remedied

In spite of these weaknesses progress has been made One can look forward to adequate social security today with greater confidence than would have been possible ten years ago In time it may be that social security will be so developed that man will no longer dread old age nor unemployment

CHAPTER 31

THE LABOR CONTRACT

The Working Population

The number of people gainfully employed in the United States is presented in Table 2

TABLE 2[1]

Sex and Census Year	*Population 10 Years or Over*	*Persons 10 Yrs or Over Gainfully Employed* Number	*% of Total Population*	*% of Pop 10 Yrs or Over*
Both sexes				
1910	71 580 270	38 167 336	41 5	53 3
1920	82 739 315	41 614 248	39 4	50 3
1930	98 723 047	48 829 920	39 8	49 5
Male				
1910	37 027 558	30 091 564	63 6	81 3
1920	42 289 969	33 064 737	61 3	78 2
1930	49 949 798	38 077 804	61 3	76 3
Female				
1910	34 552 712	8 075 772	18 1	23 4
1920	40 449 346	8 549 511	16 5	21 1
1930	48 773 249	10 752 116	17 7	22 0

The percentage of the total population which is gainfully employed has until the 30s at least exhibited a high degree of stability The percentage of the male population gainfully employed has been decreasing whereas the percentage of the total female population gainfully employed has been increasing The explanation of this increasing participation of women in gainful employment is found partly in the fact that they constitute a larger percentage of the total population In any case however a larger percentage of women are now employed than in the days when a woman s place was supposedly in the home

[1] H A Millis and R E Montgomery *Labor's Progress and Some Basic Labor Problems* (McGraw Hill Book Company Inc New York 1938) p 27 note 3

[2] Female population over 10 years of age in gainful employment

1870	13 1%	1910	23 4%
1880	14 7%	1920	21 1%
1890	17 4%	1930	22 0%
1900	18 3%		

The industrial distribution of the 48 829 920 gainfully employed in the year 1930 is presented in Table 3

TABLE 3[8]

MALES AND FEMALES TEN YEARS OF AGE AND OVER GAINFULLY OCCUPIED 1930

Industry	*Male*	*Female*
Agriculture	9 562 059	909 939
Forestry and Fishing	250 140	329
Extraction and Minerals	983 564	759
Manufacturing and Mechanical Industries	12 224 345	1 886 307
Transportation and Communication	3 561 943	281 204
Trade	5 118 787	962 680
Public Service (not elsewhere listed)	838 622	17 583
Professional Service	1 727 650	1 526 234
Domestic and Personal Service	1 772 200	3 180 251
Clerical Occupations	2 028 494	1 986 830
Total	38 077 804	10 752 116

The gainfully employed is a heterogeneous group seeking livings by pursuing many different occupations and possessing varying degrees of training and skill Table 4 presents the occupational distribution and Table 5 the percentage distribution among occupations of the gainfully employed for the years 1920 1930 and 1939 It should be noted that the absolute figures used in Table 2 differ slightly from those used in Table 4 This is to be explained by the difference in techniques used by the two organizations which compiled the totals

TABLE 4[4]

OCCUPATIONAL DISTRIBUTION OF GAINFUL WORKERS
(in thousands of workers)

Occupational Group	*1920*	*1930*	*1939*
All gainful workers	39 764	47 170	56 000
All employees	30 408	37 574	45 444
Wage earners	21 874	25 589	30 398
Clerical and sales employees	5 845	8 151	10 243
Professional employees	1 681	2 488	3 112
Managerial employees	1 008	1 346	1 691
All enterprisers	9 356	9 596	10 556
Farmers	6 387	6 012	6 614
Business enterprisers	2 573	3 101	3 411
Professional enterprisers	396	483	531

[8] *Statistical Abstract of the United States* (1937) p 54

[4] Spurgeon Bell *Productivity Wages and National Income* (The Brookings Institution Washington 1940) p 10

TABLE 5[4]

PERCENTAGE DISTRIBUTION OF ALL GAINFUL WORKERS

Occupational Group	*1920*	*1930*	*1939*
All gainful workers	100%	100%	100%
All employees	76 5%	79 7%	81 2%
Wage earners	55 0%	54 3%	54 3%
Clerical and sales employees	14 7%	17 3%	18 3%
Professional employees	4 2%	5 2%	5 6%
Managerial employees	2 6%	2 9%	3 0%
All self employed enterprisers	23 5%	20 3%	18 8%
Farmers	16 0%	12 7%	11 8%
Non farm business enterprises	6 5%	6 6%	6 1%
Professional practitioners	1 0%	1 0%	0 9%

"The Gainfully Employed

By census definition a gainfully employed person is one ten years of age or over who receives compensation usually in the form of money and bearing some relationship to the value of the service rendered for his direct participation in economic activity Exclusion from the classification gainfully employed does not necessarily imply un productive activity Women who do their own housework attest to this fact

In 1939 wage earners comprised 54 3% of the gainfully employed 27 million being engaged in non agricultural industries and about 3 million in agriculture Of those in non agricultural pursuits some 19 million were employed in mining manufacturing or transportation

Although it is usual to distinguish wage from salary earners the economic situation and the psychological attitude toward industrial problems of those in the low salary brackets are in many respects so similar to those of the wage earner that the two groups tend to have identical interests If this stratum of the salaried class—store clerks telephone operators etc —were combined with wage earners the numerical composition of this classification would increase by 10 million Wage earners would then constitute 72 3% of the total number of people gainfully employed

The Labor Contract

The sale of a laborer s service results in a contract Although the contract ordinarily is not in the form of a written document nonetheless it is creative of a series of rights and obligations The employer as his right expects to receive reasonable service for some predetermined number of hours per week the laborer as his right expects just compensation for the work he performs That part of the contract which treats of the financial compensation can be termed the monetary aspect of the labor contract that part which treats of general working conditions can be termed

the non monetary aspect It may be argued that hours tenure sanitation are as much aspects of wages as the monetary payment itself and that attempts to distinguish the one from the other are both arbitrary and unreal In defense of the distinctions it may be said that the laborer s attitude to these various aspects differs sufficiently to justify a line of demarcation

The average unorganized worker is principally if not exclusively inter ested in the monetary aspect of the labor contract Living in a pecuniary environment he becomes habituated to thinking in monetary terms His standard of living is a matter of dollars and cents Experience teaches that an inadequate wage denies those things which make living pleasant Furthermore the monetary aspect of the labor contract is highly tangible in that its form is easily comprehended and its benefits immediate

The monetary aspect is emphasized too because it is extremely diffi cult for the average industrial worker to evaluate the attending circum stances associated with the job The relative degree of danger incident to different jobs cannot easily be reduced to monetary terms If a perfectly rational choice between two opportunities had to be made it would be necessary to ascertain the monetary value of say the danger factor before the wages of the two positions would be comparable Yet if the few strikingly dangerous occupations were eliminated there is no evi dence to support the belief that the more dangerous the job the higher the recompense The workman greatly simplifies his task by reducing the problem of job comparisons to the direct money wages involved rather than attempting to evaluate the monetary worth of those other more in tangible aspects of the contract

The non monetary aspects of the labor contract however are of vital concern As long as bargaining remains an individual matter however, the average industrial worker will continue to exclude or subordinate all other considerations involved in the labor contract to that of the money wage Regardless of other reasons the necessity of giving the non monetary factors their due weight argues for collective rather than individual bar gaining Collective action focuses attention upon these non monetary factors and for two reasons first the desires of individuals acting as individuals differ from their desires when acting in concert second group action makes possible the use of agents who are competent to evaluate the worth of these non monetary factors

The Labor Market

The labor market is not one but many markets Whenever and wherever buyers and sellers of the services of labor meet to consummate a sale a labor market exists These markets can be considered either horizontally or vertically horizontally as innumerable geographic areas each with its own characteristics in which the same or similar types of skill or compe

tence are sold vertically as a series of markets superimposed one upon the other in which different types of skill or competence are sold An example of the horizontal concept is the simultaneous sale of masons services in Boston Chicago Los Angeles and Tompkins Corners The concept of the vertical market is illustrated by the sale in New York on the same day of the services of a longshoreman a lecturer an accountant and a mason

A good market exists when a large number of well informed buyers and sellers gather and through competitive bidding consummate a sale The price which is established in this mechanical fashion is a fair price judged by competitive standards

There is frequently a tendency to assume as a first premise that the bargaining position of the worker is inferior to that of the employer That the laborer is the weaker is not a generalization permissible of universal application Its validity is in indirect relationship to the degree of unionization which has been achieved by the workers under consideration and the effectiveness with which the union can enforce its demands Consequently in some markets the workers are for all practical purposes at the mercy of the employer while in others the workers prove a powerful force which must be handled with great consideration and skill

Ordinarily the unorganized worker is in a weak bargaining position What the laborer has to sell—services—is more perishable than a banana Should a day s labor not be sold it is lost lost forever for there is no way of storing it for future sale The laborer s choice in the matter of jobs is limited by the size of his money reserve To refuse the offer of employment requires a money reserve sufficient to support the declining laborer and his family until a better opportunity appears In the absence of a reserve the acceptance or rejection of any specific job is a non existent choice The laborer is further handicapped by his immobility His services will command a higher price only if he be free to move to that place or occupation where his abilities are at a premium But mobility requires knowledge of where these better opportunities are to be found the financial means of getting to that place and the ability to perform such tasks as are there available The absence of all or any one of these may imprison a worker within the confines of an unfavorable market as effectively as though he were bound by chains

When one considers the labor market as it is—a highly complex mechanism establishing prices for unorganized and organized workers for workers of rare skill and for those possessing nothing but physical strength, for the employees of small individually owned businesses as well as those of gigantic corporations—it becomes evident that it is not the ideal market of perfect competition but an imperfectly competitive market If one of the groups entering into the bargaining—whether employers or employees—be small in number compared to the other it

possesses a potential advantage an advantage upon which it will strive to realize Since employers are usually relatively few and better informed as to the value of that which they purchase the advantage ordinarily rests with them

Determination of Wages

What are the forces which determine the wage paid a laborer? The most frequent but unfortunately the least informative reply is the operation of the old law of supply and demand That answer however fails to explain why the demand is as it is or why the supply is what it is

The employer regardless of his personal philosophy must if he is to be judged successful make a profit If production costs exceed selling price his efforts as a business man prove futile From experience and with the aid of an accounting department the employer can approximate quite closely the value contribution made by labor Equipped with this knowl edge the employer can estimate the maximum wage he can afford to pay This doesn t mean that this amount will necessarily be paid all that it does signify is the most that can be paid

The employer knows also that with his plant and equipment he cannot increase the size of his labor force indefinitely without affecting the average output per man At some point the value of the additional output which an added worker makes possible would not be justified in light of the wage he must be paid If the employer should experience an expansion in the demand for his product the enhanced price would make labor more valuable and hence he could without endangering his profits hire more workers

The working population consists of many diverse groups possessing varying degrees of skill and ability The resulting compartmentalizing of the laboring force limits competition for specific jobs to the members of fairly well defined groups A shortage of surgeons can no more be com pensated for by drawing upon even the most proficient butchers than a lack of machinists can be offset by an overabundance of actors Too the supply of labor is a function of price High wages attract greater numbers than low wages Hence the supply of labor refers to the number of workers who stand ready to accept employment at specific jobs at some definite wage

The worker if he be a man of experience knows approximately the value of his services This knowledge militates against the ready acceptance of a wage below this amount Accustomed to a given standard of living he is reluctant to accept a rate of compensation which would necessitate living on a lower plane Finally there is an irreducible minimum a wage which rather than accept the worker would prefer public or private relief

The maximum that the employer will pay sets the ceiling of wages and the irreducible minimum acceptable to the laborer sets the cellar Between

these two extremes a bargaining area exists How close the actual wage paid will approach either of these two points will depend upon the relative bargaining strength of the two parties And the decisive factor which determines strength in bargaining is the relative number of employers and employees

The Trend of Wages

The economic position of the workman depends both upon his money wage and the ability of that money wage to command goods and services When the money recompense is translated into goods and services it becomes the real wage It is this 'real wage which determines the standard of living of the employee To have been a millionaire in Germany during the period of hyper inflation would have yielded the empty satisfaction of a pocketful of money and a stomach full of hunger To ascertain the well being of the laboring group it is necessary to determine the number of hours worked per week the number of weeks worked per year and then the ability of this money wage to command goods and services

Since 1920 the annual earnings of workers attached to industry has declined The fall in money wages (over 30%) was in part counteracted by the downward movement of prices Yet in spite of this compensating tendency, the real income of workers fell some 20% And it is interesting to note that this occurred even though the hourly earnings during this same period increased This seeming contradiction is explained by the decrease in the number of hours worked by large segments of the gainfully employed and the widespread unemployment which marked the 30s

The manufacturing industries offer a statistical picture of the movement of money wages in the years 1929, 1932 and 1936 Those workers who were fully employed in manufacturing received an annual wage of $1 337 in 1929 $1 118 in 1932 and $1 373 in 1936 Workers who were partially employed in these industries, that is those who experienced relatively short lay off periods received $1 315 in 1929 $909 in 1932 and $1,138 in 1936 Those workers who worked in the manufacturing industries when they could get jobs that is those technically attached to manufacturing " received $1 246 in 1929 $533 in 1932, and $957 in 1936

During the last twenty years the percentage of the national income disbursed to the gainfully employed increased from 81% to 84% As has been pointed out however the gainfully employed as a group is not identical with what is commonly thought of as workers If the term worker should be used synonymously with industrial worker then the workers' share in the distribution of the national income declined from 29% to 24% during this twenty year period

Minimum Wage Legislation

By 1940 twenty six states, the District of Columbia, Puerto Rico and Alaska had enacted some form of minimum wage legislation The Fair

Labor Standards Act[5] and the Walsh Healey Public Contracts Act extend the scope of federal minimum wage legislation The first of these covers industries engaged in interstate commerce or in the production of goods entering into interstate commerce and the latter covers those businesses which accept contracts with agencies of the federal government in amounts of $10 000 or more

The state laws with a single exception (Connecticut) cover only women and children It has been estimated that approximately 4 million workers or well over a third of all employed women and children will receive similar protection when full effect is given to [minimum wage] legislation now on the books [6] The Fair Labor Standards Act applies to men as well as to women and children and the Bureau of Labor has estimated that some 12 600 000 workers will benefit by the legislation And to this number should be added those workers who although not covered by the Fair Labor Standards Act are covered under the provisions of the Walsh Healey Public Contracts Act

Prior to the passage of the federal legislation minimum wage laws were instituted primarily for the protection of women and minors It was firmly believed by the proponents of this type of legislation that women and minors were incapable of protecting their own interests The unorganizability of this group denied the protection which might have come through unionization And for this group to rely upon competition to insure an adequate wage was to depend upon a weak reed indeed If this group relied upon its wages alone for its support its standard of living would be so reduced as to threaten its health If the accompanying poverty proved too much to bear it is conceivable that some of the women would turn as a means of supplementing their meager incomes, to what is euphemistically termed evil pursuits To protect these wards these women and minors incapable of self protection the states instituted minimum wage legislation

The endeavor of the states to provide this protection was constantly running afoul of the 14th amendment In 1917 the Supreme Court upheld the minimum wage legislation of the state of Oregon in a 4 to 4 decision [7] In 1923 however the Court invalidated the minimum wage law of the District of Columbia [8] This decision appeared at the time to have settled the constitutionality of minimum wage legislation once and for all Nevertheless in 1937 the Supreme Court in the West Coast Hotel vs Parrish [9] case reversed the position it had taken the year before in the Moorehead vs Tepaldo case [10] and in a decision delivered by Chief Justice Hughes

[5] This legislation is more commonly known as the Wages and Hours Act

[6] Frank Pierson Determination of Minimum Wage Rates in *American Economic Review* Vol XXX No 1 March 1940

[7] Stettler vs O Hare 243 U S 629 1917

[8] Atkins vs Children s Hospital case 261 U S 525 1923

[9] 300 U S 279

[10] 298 U S 587

upheld the minimum wage legislation of the state of Washington This decision reopened the possibility of securing a legal end—the health of women and minors—through what was now a constitutional means—minimum wage legislation

The Fair Labor Standards act of 1938 provides for minimum wages and maximum hours for workers employed by industries engaged in interstate commerce or industries whose products enter into interstate commerce [11] The administration of the act is lodged in the Wages and Hour Division of the Department of Labor The basic law prescribes that (a) not less than 25¢ an hour shall be paid by the affected employers the first year beginning October 24 1938 (b) not less than 30¢ an hour shall be paid during the next 6 years (c) and not less than 40¢ an hour shall be paid thereafter The law also states that the standard work week shall be (a) 44 hours for the first year beginning October 24 1938 (b) 42 hours a week during the second year and (c) 40 hours a week from then on Flexibility in the administration of the law is secured by granting to the Administrator of the act functioning in conjunction with a committee representative of the industries under consideration the right to set minimum wage rates at any point above the minimum prescribed by law but not in excess of 40¢ an hour as long as the result does not abridge an existing collective bargaining agreement

The Fair Labor Standards act has not been in operation sufficiently long to permit one to speak with finality of its effects There are economic problems involved in minimum wage legislation however which bear consideration If as a result of minimum wage legislation wage rates should approach but not exceed the value of the laborer s contribution to the productive process there is no reason to anticipate subsequent readjustments in employment conditions For those workers who do not receive the full value of their services minimum wage legislation may accomplish authoritatively what free competition has failed to achieve automatically If the law should push wages above the value contribution of the worker, employment readjustments would be inevitable The employer may endeavor to compensate for his enhanced labor costs by substituting machines for men wherever possible thus the number of workers technologically unemployed may be increased Or he may strive to offset the resulting advance in labor costs by reducing the size of his working force If the increase in costs could be passed on to consumers in the form of higher prices, the added burden may be justified socially It may be better social policy to spread the costs of a higher standard of living for the poorly paid section of the people over the group as a whole rather than to permit them to continue in their poverty The key to the economic problem involved in minimum wage legislation is to be found therefore in the relationship which the

[11] The constitutionality of the act has as yet not been decided

wage established bears to the value of the affected workers contribution to the production process A sufficient degree of flexibility in the adminis tration of the law is necessary if employment maladjustments are to be minimized

The Trend of Hours[12]

The earliest endeavors in the United States to reduce the length of the standard working day met a form of opposition with which it is most difficult to cope As long as leisure was considered the handmaiden of vice the sun up to sun down rule was sanctioned by a condoning public opinion In the latter part of the eighteenth century workmen were passing resolutions to the effect that a day s work should not begin before six in the morning nor extend beyond six in the evening And in the early decades of the nineteenth century workmen in some occupations were already striving to realize their dream of a ten hour day

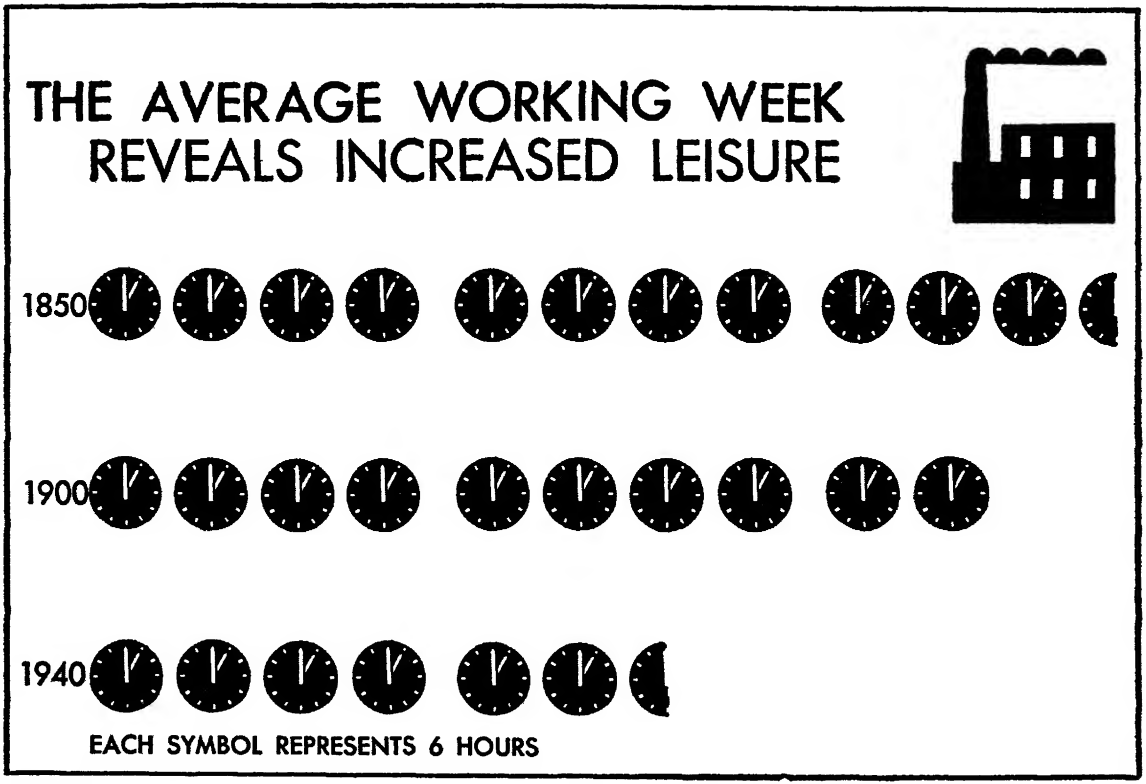
The movement to reduce the length of the standard working day has continued The success which has attended this endeavor is best attested to by the continuing decline in the number of hours which constitute the standard working day

In 1890 the average length of the work week for industrial workers was 58 5 hours This average varied however as between industries and as between unionized and non unionized plants within an industry The average length of the working week in the building trades was 51 3 hours while coal miners labored 60 hours Until the advent of the World War the gains made by labor were steady but moderate This period (1890 1914) witnessed a growing demand by labor for the acceptance by industry of the eight hour day and the agitation resulted in its acceptance in certain areas and by certain industries Between 1915 and 1920 marked progress was made In 1920 the average length of the work week for all industries was 50 4 hours Among unionized manufacturing plants the average fell to 45 7 hours The average number of hours worked in the building trades per week was 43 8 and among coal miners 48 2 Thus between 1890 and 1920 the average length of the work week for all employees in all industries fell by eight hours

Although the average length of the working week decreased between 1890 and 1920 for the employees of the manufacturing industries there was a dispersion of the individual items around this average[13] Thus a reduction in the length of the work week does not necessarily benefit every workman to the same degree The average can decrease yet there will continue to be some industries or some plants within an industry that will

[12] The statistical material used in this section is drawn from H A Millis and R E Montgomery *Labor's Progress and Some Basic Labor Problems* pp 463 488

[13] Of these workers 51 5% worked 48 hours a week or less 18 2% between 48 and 54 hours 7 8% 54 hours and 12 6% between 55 and 60 hours and 9 9% 60 hours or over



[By permission of Pictograph Corporation]

display a Gibraltar like resistance to the general movement Despite exceptions to the general rule the period between 1890 and 1920 is characterized by the replacing of the ten hour by the eight or nine hour day as a standard

The rate at which hours were reduced in the 1915 1920 period did not continue into the decade of the 20s Marked gains were made in certain specific fields however Between 1922 and 1924 the steel industry at last abandoned the twelve-hour day The Saturday half holiday became an accepted practice, and the five day week appeared in the building trades By 1929 38% fewer employees of manufacturing enterprises were working the sixty hour week than in 1920 There was a change however in the percentage distribution of hours among workers in manufacturing industries during this decade [14] This resulted chiefly from the replacement of the forty eight hour week (32 6% in 1919 and 26 5% in 1929) by the fifty odd hour week

The movement of hours during the decade of the 30s is less sharply defined Until this period the agitation for a shorter work week had emanated primarily from the ranks of labor The gains which had been achieved were less in the nature of small continuous reductions and more in the nature of movements from one plateau to another and lower plateau And what was of special importance to workers was that these reductions had not been accompanied by a fall in weekly income In short they were truly gains The 30s however marked the acceptance of the shorter work week by many groups and for a variety of reasons Some proponents saw in its temporary acceptance a means of mitigating the worse effects of cyclical unemployment There were others who believed that the shorter work week was a concomitant of modern technology Too the underconsumptionists saw in the reduction of hours a means of expanding the purchasing power of the masses The interplay of these forces the presence of widespread unemployment and the introduction of the National Industrial Recovery Act obscure what rather inaccurately may be termed the true trend of hours during this decade and make difficult predictions concerning future trends

Although this decade was characterized by the interplay of complex and confusing forces certain general tendencies relative to the trend of hours are discernible The spread the work policy was losing its support by 1933 It had been looked upon by its sponsors from the first as nothing more than a temporary expedient to be abandoned with a return of more prosperous times The invalidation of the National Industrial Recovery Act was followed by some lengthening in the hours of work By the end of the decade however the forty to forty four hour week was being accepted with increasing favor by a growing segment of industry

[14] While in 1919 16 5% of the wage earners in manufacturing worked between 48 and 54 hours a week this percentage increased to 24 8% by 1929

Whether these gains can be maintained will depend primarily upon the ability of the country to carry forth its rearmament program without extending the length of the working day

Maximum Hours Legislation

The right of the Federal government to regulate the length of the standard working day for its employee was constitutionally established in 1903[15] By 1912 the eight hour day had been extended to practically every employee of the national government During the 30s people employed on federal relief or public works projects were prohibited from toiling more than eight hours a day or more than 140 hours a month In 1936 the enactment of the Walsh Healey Public Contracts Act made it mandatory upon those companies which accepted government contracts to adopt as a standard the eight hour day and the forty hour week for all workmen engaged in fulfilling the contract The history of federal maximum hour legislation portrays a continuing effort on the part of the government to reduce the length of the standard work day and to broaden the coverage of the standards attained

Legislation setting the maximum length of the working day for men in private employment moved at a pedestrian pace Such legislation as was passed was restricted to hazardous occupations and transportation The right of the state to act in these spheres was sustained in 1898 on the grounds that such men were wards of the state[16] However before the state could exercise this power the hazardousness of the occupation had to be established in fact[17] If the fact could not be proved to the satisfaction of the Court then the state was held to have exceeded its police power and was consequently trespassing upon the 14th amendment In 1917 the Court in the Bunting vs Oregon decision[18] apparently sanctioned the right of the states to set a ten hour maximum day for men working in mills and factories provided that overtime work was permitted and paid for at special rates This latter decision has left the issue of how far the state can proceed in this matter confused There seems to be no doubt, however that once the fact of danger incident to an occupation has been established the state can determine the maximum length of the working day in that industry

The constitutional right to determine the standard working day for men employed in transportation rests in the case of the individual states, upon the exercise of the police power and in the federal sphere upon the power to regulate interstate commerce[19] To permit men to operate common carriers

[15] Atkins vs Kansas 191 U S 207 1903
[16] Holden vs Hardy 169 U S 366
[17] Lochner vs New York 198 U S 45
[18] 243 U S 246
[19] Baltimore and Ohio vs Interstate Commerce Commission 221 U S 612 Wilson vs. New 243 U S 332

excessive hours is held by the Court to be detrimental to the safety and health of the general public In 1916 the Adamson Act was passed which created a basic eight hour day for railway employees engaged in inter state commerce There is reason to suspect that this act was passed pri marily to facilitate the securing of overtime by workers and thus avoid a threatened strike rather than to protect the physical well being of the public

In contrast to men women are protected in varying degrees against unduly long hours in all but five of the states The right of the individual states to enact protective legislation for women involved the issue of whether they because of their sex needed the special protection of the law In 1908 the Supreme Court decided that the health of women was of greater importance than their constitutional right to work themselves into a sanitarium and upheld the statute of the state of Oregon limiting the hours of work for the weaker sex [20] This decision was subsequently rein forced when the Court upheld a Colorado law limiting the length of the working day for women to 8 hours [21]

Although legislation is enforced in most of the states the coverage varies widely The laws differ as to the number of hours that shall con stitute the standard working day, as to the specific industries that are covered as to whether overtime or Sunday work shall be permitted and as to whether women shall be permitted to work at night Two of the most laborious occupations in which women work probably the longest hours are not generally covered—agriculture and domestic service There is need for greater uniformity in this type of legislation for more extensive coverage for more thorough enforcement, and for the setting of a standard week as well as a standard day

Hours and Fatigue

The complete man should be something more than an automaton created to wear itself out in the monotonous unending routine of pulling and push ing a lever Working too many hours for too many consecutive days at some repetitive task exacts a toll of the worker Fatigue is cumulative and unless adequate rest is provided at frequent intervals health will give way It is possible that work has never hurt anyone but excessively long hours have contributed their bit to the piling up of human wreckage There are those so it is said whose undeveloped mentality makes of a dull monoto nous task a joy forever But if these fortunates be excluded unduly long hours at some highly specialized and to the worker often meaningless task affects his attitude toward his cultural environment Relief from the drudgery may be sought in forms of recreation which while not imagina tive are most exciting temporarily and very wearing permanently His

20 Muller vs Oregon 208 U S 412
21 Miller vs Wilson 236 U S 373

attitude toward his family his friends and the state may become, if not anti social at least warped

A reduction in the length of the working day is from the standpoint of fatigue advantageous on two counts Obviously one is less tired when his hours are reduced from say twelve to ten or ten to eight How far this curtailment can or should proceed depends upon the relationship which hours bear to labor s productivity and also upon the particular type of work being performed As hours are reduced the problem of the utilization of leisure grows in importance It is not being overly hopeful to anticipate an intelligent use being made of this added free time especially if the schools and the state become as interested in one s avocation as in his vocation Men who have not been dulled by excessive hours do not ordinarily hunt out vicious forms of recreation There seems to be no good reason for assuming that workers are inherently less capable of enjoying the finer things than others more fortunately situated

Hours and Labor's Productivity

Labor is a cost of production and as such must be met by the employer The real cost of labor however is not the amount paid per hour nor per week but the labor costs per unit of product A Chinese coolie at 20¢ per day may because of his low productivity be far more expensive than a skilled mechanic at $1 00 an hour How far this reduction in hours can be carried however before per unit prices must be advanced or wages reduced, depends upon the relationship which exists between hours and productivity Naturally if a shortening in the length of the work day should so increase daily output that the workman produces more than he formerly did it is to the mutual advantage of both the employer and the employee to sponsor a reduction in hours

It has been found that a reduction in hours from twelve to ten or ten to eight has generally resulted in an increase in the daily output per worker One should not infer from this fact however, that continued reductions will consequently yield the same result There is some point some given number of hours, below which the daily output of labor will decline The ideal number of hours—the optimum—from the standpoint of productivity would be those which maximized daily production And this optimum would vary as between industries and as between occupations

What if hours should be reduced below this optimum and daily wages were to remain the same? First it should be remembered that the labor is not the only cost of production, there is also a capital cost With a given capital investment a fall in output would increase per unit costs because overhead would now be spread over fewer units The per unit cost of production measured in the labor factor would also increase for labor would now be receiving the same wage for a smaller volume of output The rise in per unit cost would occasion an increase in per unit price The enhanced

price would tend to decrease the demand for the goods which in turn would increase the volume of unemployment

This tendency may be offset by changes which may occur in the industry affected The capital cost per unit of output may be reduced by increasing the number of shifts per day By employing the capital equipment a greater number of hours per day, the overhead would be spread over a greater number of units The economy thus achieved might compensate for the increase in cost occasioned by the decrease in labor s productivity There is also the possibility that with time technological improvements or increased managerial efficiency would increase the productivity of labor The point to be made however is this that with a given technology and with a given degree of managerial efficiency a reduction in the hours of labor below the optimum will cause an increase in per unit costs

Accidents and Health

The worker may find after accepting employment that the conditions within the shop are conducive to accidents or ill health If the worker had been cognizant of these facts before accepting employment and if he had been competent to evaluate their monetary worth it could be contended that the money wage compensated for the greater degree of risk incident to his particular job Since necessitous men are not free to pick and choose and since the ability to calculate the monetary worth of these risks is beyond the ken of the ordinary worker he in the absence of protective legislation, customarily assumes these risks himself If a serious industrial accident should occur or if his health should be undermined by some occupational disease the average workman is called upon in the absence of Workmen s Compensation legislation to assume a burden far beyond the ability of his limited means to bear

The seriousness of this problem is best indicated by its extent Although estimates vary the calculations which have been made have resulted in figures of impressive size In 1908 Dr Frederick L Hoffman [22] estimated that from 15 000 to 18 000 American workers were killed each year in fatalities *directly* due to job hazards and some 2 000 000 workers were injured more or less seriously In 1923 industrial fatalities numbered 21 000 117 000 employees were permanently or partially disabled and 2,000 000 workers were temporarily disabled The National Safety Council estimated that in 1933 about 15 000 workers were fatally injured and roughly 1,200 000 employees suffered non fatal accidents

Such studies as have been made by insurance companies of illness indicate that the incidence among industrial workers far exceeds that among the rest of the population When the causes of illness are examined the evidence appears to establish a close correlation between illness and the

[22] The statistics herein used are drawn principally from C R Daugherty *Labor Problems in American Industry* (Houghton Mifflin Company Boston 1938) pp 114 130

type of work performed One can infer from the data that insanitary working conditions the handling of certain kinds of materials and extremes of temperatures are important factors in explaining the high sickness rate among industrial workers

Industrial accidents and occupational disease involve costs There is the direct cost of hospitalization doctor s fees medicine etc These are the quite obvious costs Less obvious are the costs incident to the ensuing wastage of human resources an ill or injured worker is a resource running to waste If the injured employee be replaced there is the cost of training the new workman Materials or machines may have been damaged either as a result of the accident or by the new workman during his training period In short industrial accidents involve a cost not only to the affected worker but also to his employer and society as well

In spite of the introduction of protective devices the enactment of government legislation, and intelligent management injuries continue to occur The issue is who shall bear the costs of such accidents

Under the common law the injured workman could recover for the injuries he sustained by bringing suit against his employer It was obligatory upon the employer to provide a safe place to work safe tools with which to work and competent fellow workmen The injured workman to have his suit sustained had to prove in a court of law that his employer had failed to provide these reasonable conditions of employment If he succeeded the employer was compelled to render compensation

This procedure placed the workman in a disadvantageous position Not only did the suit involve great expense to the worker not only was the process time consuming but the law itself tended to operate to the advantage of the employer If the employer could prove contributory negligence on the part of the injured worker or even on the part of the affected worker s fellow employees the employer regardless of his negligence was absolved Furthermore if it could be established that the injury was the result of a risk normally associated with the type of work being performed the employer could not be held responsible It was not overly difficult for the employer to establish one of these defenses particularly when he was in a position to hire competent legal talent The affected employee therefore not only suffered the injuries but frequently bore the financial burden as well

Workmen s Compensation Legislation

In 1936 all the states except Arkansas aand Mississippi had enacted Workmen s Compensation legislation These systems are of two general types the compulsory and the elective form The compulsory type leaves no choice to the employer other than that of complying with the mandatory provisions of the law In consequence he is subject to predetermined rates of contributions to defray the costs of the program and he receives benefits

according to a predetermined schedule of payments Under the elective system the choice of joining a compulsory system or not rests with the employer The choice however is less effective than appears at first sight If the opportunity to participate in the program is rejected the employer is automatically denied the right to use the common law defense of con tributory negligence Denied this the employer loses his principal defense in a court of law

The statutes now in force are not complete in their coverage The degree of inclusion varies with the individual states Generally workers employed in agriculture domestic service or engaged at casual occupations do not come under the provisions of the acts The customary procedure is either specifically to designate those occupations considered to be hazardous or to apply the law to every business which employs workers in excess of some minimum number Attempting to specify which occupations are truly hazardous is apt to prove both arbitrary and to the workers in the non covered industries highly unsatisfactory A more effective method would be to reverse the procedure and apply the law to all employments unless specifically exempt To have one s hand snatched off by a machine only to learn that legally the occupation is non hazardous may seem exceedingly unreal to the workman sustaining the injury

The ideal benefit is that which would continue the injured employee s income undiminished until he again returns to his accustomed task If this ideal should be achieved the burden would then be lifted from the worker This ideal however is still to be reached Ordinarily the benefit is computed as a percentage (50% or 66⅔%) of the affected worker s weekly wage and is paid for some predetermined period of time The benefits also vary with the severity of the injury If death should result a sum equal to three to four years wages is paid to the survivors in weekly instalments If total disability results the injured workman receives a weekly benefit of between one half and two thirds his wage In most states this benefit is paid for some predetermined number of weeks in others the payment continues as long as the worker lives Partial disability results in benefits of varying amounts and for limited periods of time The major problem incident to partial disability is equitably indemnifying the affected worker if when returning to work the injury should adversely affect his earning capacity The law of some states Wisconsin for example ascertains the percentage decrease which has occurred in the worker s income and then applies this percentage to the benefit he receives for total disability the resulting sum is the compensation the worker receives This amount is then paid him for some maximum period of time

Conclusion

Because of the complexity of the labor market the average unorganized worker is usually under a disadvantage when selling his services The pay

ment he receives is frequently apt to be below the value of his services He standing alone can do little his choice often rests between accepting what is offered or remaining unemployed As he grows conscious of the limitation he suffers when acting as an individual he strives to compensate for this weakness by acting in concert with his fellow workers Unionism may become his one and only hope

CHAPTER 32

UNIONS OF THEIR OWN CHOOSING

Attitudes toward labor organizations unfortunately are often not the result of reasoned opinion but reflect the mental patterns of the income or social group into which one happens to be born Frequently this accident of birth makes some conceive of a labor organization as a pernicious despicable institution destined in the end to destroy all that is good and deserving of perpetuation while to others labor organizations are beneficent conceived in reason and dedicated to the highest of social purposes the protection of the weak and disinherited Emotions are aroused when unionism is discussed prejudice not uncommonly replaces reason ignorance supplants understanding Like other social institutions unions are never as bad as their bitterest enemies claim nor as stainless as their warmest admirers believe Yet if one is to comprehend the world in which he dwells he must with this as with other institutions endeavor through inquiry to understand a union as a social phenomenon which appeared with the advent of the employee employer relationship

Definition of a Labor Organization

A labor organization is a continuous voluntary association [1] of wage earners combined for the purpose of improving the labor contract primarily through the use of collective bargaining Collective bargaining it should be noted is not the sine qua non of unionization labor organizations may elect to attain their ends through the medium of legislative enactment It should not be inferred that the two methods are mutually exclusive in fact it is customary for unions to use them jointly Although collective bargaining has played the more important role in the drama of the labor movement there are signs which portend an increasing use by labor of political pressure Labor organizations as the term is herein applied excludes those sporadic ephemeral combinations of workmen which on occasion spring into existence overnight for the purpose of achieving some specific end, only to disintegrate and disappear as soon as that end has been achieved Continuity is of the essence

The fundamental interests of a labor organization are economic in character Its primary objective is to obtain for the worker a larger participation in the income disbursed by industry It may and often does carry

[1] The term voluntary association is used in contradistinction to the term incorporated

on many other activities which range over a wide field of endeavor Insurance programs are instituted social activities are encouraged and educational projects are sponsored Yet important as these activities may be they are nonetheless only adjuncts to the more basic purpose for which the union exists The presentation of Pins and Needles does not make the Ladies Garment Workers a union but the fact that it was *a* union makes possible the presentation of the show If a labor organization should become so engrossed in these peripheral activities that it permits its interests in the economic objective of its members to atrophy or lag it ceases to be a labor organization and becomes a social organization In short a labor organization is something more than a group of wage earners acting in unison it is workmen acting collectively to improve the conditions of employment

Men turn to labor organizations for a variety of reasons but as varied and good as these may be the real reason stems from the conviction that union membership enhances their opportunities of securing a more favorable labor contract Aware that under the existing system of production their status as wage earners is not likely to change aware too that the opportunity to escape into the employer class is non existent for most the one obvious remaining means of improving their standard of living is by exacting a higher reward for the services which they have to sell An awakened consciousness among laborers of the futility of individual bargaining in the non competitive market in which they offer themselves for hire makes action in concert a substitute to which they turn most willingly

Types of Labor Organization

The social and industrial environment in which a labor organization must function will affect its structural form Since the primary object of a union is to better the labor contract intelligent leadership will strive to mold the union into that form which will maximize the bargaining strength of its members The adaptation of structural form to industrial environment may or may not be made expeditiously Intrenched interests incompetent leadership or mere human inertia may militate against easy and ready readjustments being made to social and economic change One would naturally expect unions to exhibit differences in structural form in a highly mechanized economy than in an economy in which the dexterity of the skilled craftsman sets the pace Yet since all parts of the economy do not change at the same rate since the most improved technological methods dwell side by side with the handicraft system of production unions adhering to different structural forms will be coexistent For purposes of presentation therefore labor organizations will be divided structurally into three basic types craft unions industrial unions and labor unions

Craft Unions

A craft union is a labor organization which brings into association as members workmen who perform the same or closely related trades Eligibility for membership is based upon proficiency at some specific trade the mysteries of which can be mastered only after a relatively long period of apprenticeship Thus carpenters are joined together in a carpenters union just as plumbers are united in a plumbers union Today however many unions still traveling under the label of craft unionism have failed to retain their original purity of trade Expediency has necessitated the extension of membership beyond the rigid limits set by a single craft

The very basis upon which craft unionism is established—mastery of a skill—tends to preclude the members as craft unionists from having more than an academic interest in labor when spelled with a capital L Nor have they any abiding concern in those schemes which look to the eventual replacement of capitalism by some other type of economic system To them utopias are for men of less practical ilk They are business minded Their principal objective is to make the trade which they practice command as high a reward within the framework of the existing system, as lies within their power And in order that this end can be attained they strive to protect their craft against the encroachments either of other workmen or of machines as well as by restricting the number of workmen capable of practicing their trade Their attitudes and policies have among less skilled workmen earned for them the appellation of the aristocrats of the labor movement

The primary unit of organization in craft unionism is the local union The local claims jurisdiction over all craftsmen practicing a given trade within a given delimited locality usually a city If the membership of a local however should grow so numerous as to become administratively unwieldy several locals of more manageable proportions would most likely be established within that area If this should occur a district board composed of representatives of the various locals within the community is created These representative assemblies determine local policies subject however to ratification by popular vote of the membership of the locals This technique has the advantage of efficiency over the alternative of attempting in a mass meeting of the entire membership to reach decisions

Although each local craft union jealously maintains its separate identity and tenaciously clings to its sovereign rights occasions arise when concerted action to achieve some common end becomes strategically desirable Thus all unionized workers in say some anti union city may feel the compulsion to present a common front against employers In order that this type of unified action can be resorted to with a minimum of friction City Federations are created The various locals voluntarily cooperate through the representatives which they send to these central bodies Thus

a modus operandi is brought into existence which permits the locals to affiliate for cooperative action without losing their separate identity or surrendering their autonomy

As the locals increased in numbers and as they spread over a wider geographic area national craft unions emerged Problems of mutual concern arose and in order that acceptable solutions could be found a coordination of the activities of these separate independent local cells became necessary With a multiplicity of local units standards which would secure uniform practices among the locals became imperative if orderly procedure was to be achieved The matter of admission to membership is illustrative of this point If each local were left to its own devices admission rules might be as varied as the locals were numerous The obvious means of circumventing this possible difficulty was to establish a uniform set of admission rules to which all the locals would adhere The logical place for these rules to be decided upon was in a national organization Hence the first power delegated by the locals to the national union was the right to determine admission requirements Soon the 'traveling card made its appearance This card which originally was to facilitate the movement of workers from one locality to another by giving evidence to the fact that its holder was a union member in good standing became a device through which the national union increased its power A workman would hesitate to act counter to the rules of the union knowing that the withdrawal of his union card automatically excluded him from work on all union jobs Until the 1880s the national craft unions exercised authority in a very restricted field namely the determination of rules pertaining to membership and matters relating to the movement of workers between communities In short the national union was a confederation to which limited powers had been delegated by a group of sovereign locals

It was during the 1880s that the autonomy of the local unions in many trades began to disappear Until this time it had been customary for each local to make its own decision as to when it would strike and how it would conduct the strike after it had been called The chief assistance extended the local by the national at this time was to keep the members of other locals out of the town on strike If the striking local felt the pinch of inadequate funds it would request financial aid of the other locals These requests rarely elicited generous responses Most often they brought replies couched in the language of labor s solidarity but unfortunately empty of cash The need for a more comprehensive and effective plan for waging strikes finally led to the creation of the "Defense Fund" This was a fund created from the contributions made by the members of all the locals and was to be used to assist any local when engaged in a strike The custody and control of this money was placed in the hands of the national organization And with the passage of the control of this fund into the hands of the national organization passed the autonomy formerly enjoyed by the local

Control over the purse strings led to the establishment of a permanent continuing body of national officers Management of the funds required something more than assuring their safe custody decisions had to be reached relative to their disbursement When was a local justified in expecting financial assistance from the national and for how long a period? Knowledge that a strike called without the sanction of the national meant sacrificing the financial assistance now made possible by the defense fund ultimately transferred the strike decision from the locals to the national When it is remembered that so very many of the decisions made by locals relate to strike matters this transfer of the final strike decision was in fact a transfer of sovereignty

Today in most craft unions the national is the fountain head of authority the locals have become nothing more than administrative units Although annual or biannual conventions are held and representatives from the locals attend these meetings they have tended to become a form without content The executive board of the national can control the issues which will be submitted to the delegates for their consideration It is exceedingly difficult for the locals to initiate proposals or to act in unison against the executive board of the national In the interim between conventions communication between locals is not easily achieved The medium of information—the union journal—is issued through the national organization and consequently, is under the supervision of the national officers In most of the advanced unions control has become centralized in the national, the conventions even have passed into innocuous desuetude frequently being mere social gatherings

The generalizations made above relative to the form and organization of craft unions are subject to limitations Necessity bred of modern technology has compelled many craft unions to abandon their original purity of trade and admit to membership less skilled workmen workmen who once would have been beyond the pale Too the increased centralization of administration is made more conspicuous by several outstanding exceptions the most noted of which is to be found in the building trades Here the locals, affiliated in their building trades councils have retained a high degree of autonomy

Advantages of the Craft Form of Unionism

Since the ticket of admission to a craft union is an achieved degree of proficiency at a specific task homogeneity of membership results Carpenters or plumbers may differ as to height weight or color but engaged as they are in the same craft and receiving approximately the same compensation similar attitudes, engendered by common interests and training evolve, yielding a unity of purpose not easily destroyed A cohesion develops which gives to the group a strength greater than that of any single member This advantage decreases as expediency forces the union to extend its

membership to include a wider variety of occupations and more varying degrees of skill

There is also a technical advantage which rests in the craft form of organization The skill of any individual craftsman within a given trade is not likely to diverge markedly from the average ability of the group as a whole A uniform rate of pay can therefore be determined more easily for all those practicing the craft and what is possibly of even greater importance it can be applied without developing a feeling of unfair dis crimination as between workers This lessens the possibility of internal disharmony

Skill the quintessence of craft unionism is of inestimable strategic value in collective bargaining The withdrawal of skilled workmen is more than the walking out of a group of employees skill leaves with them skill which cannot easily be replaced especially if the craft be well organized This monopoly over skill gives to those unions in this enviable position a strength which far exceeds the numerical size of their membership Thus the wall paper engravers few in number but highly skilled can force almost any concession they desire It should be remembered that the problem facing the employer is not merely one of replacing a given number of workmen but is that of finding the necessary number with the ability and training to do the job

Disadvantages of Craft Unionism

If the labor movement is conceived of not as an exclusive club to which only an elect group of nabobs is eligible but as a movement which strives to improve the lot of the mass of workers then, craft unionism stands in dicted indicted because by its very nature it excludes from participation in membership all low skilled workers It is on the horns of a dilemma to open the gates to all comers is to abandon craft unionism to preserve its pristine purity by maintaining its exclusiveness is to forsake the mass of workers To extricate itself from this dilemma by admitting some and excluding other unskilled workmen may result in an organization which is neither fish fowl nor good craft unionism

The craft form of organization is not well adapted to a society in which the machine with a persistence matched only by its own efficiency, has been replacing one skill after another Technological advance thus saps the vitality of the pure form of craft unionism

One of the most oft-noted criticisms of craft unionism is that its escutcheon is besmirched by jurisdictional disputes especially that type known as the demarcation dispute Demarcation disputes result from the inability of unions to agree as to which shall have jurisdiction over certain, particular tasks To illustrate Which union should have jurisdiction over the painting of telephone poles the Painters or the Electrical Workers? Which union should have jurisdiction over the boring of holes for metal

pipes in wooden floors the Carpenters or the Plumbers? The inability of unions to settle these disputes satisfactorily has contributed to the enrichment of some peoples repertory of amusing anecdotes The amusement can hardly be long lived when one recalls that these disputes have frequently resulted in internecine warfare Protracted cessation of work not because of any disagreement between employer and employee but owing to the inability of workers to agree among themselves in the eyes of many discredits the whole labor movement It is discouraging to the average citizen as well as exceedingly exasperating to the employer to see production halted because two unions cannot agree as to which should do some particular job Months may pass before a demarcation dispute is settled months during which laborers are unemployed production is curtailed expenses mount and the public is left to gaze in bewilderment

Such disputes although they may result from misconceptions are not engaged in to satisfy some vicious stupid yen to battle Many unions like many laymen accept the lump of work theory the theory which holds that there is but so much work to be done Accepting this theory the union reasons that to permit the smallest part of a task to fall to other workmen robs the members of the surrendering union of just that much employment The fact that the theory is erroneous matters little as long as unions like other people insist upon believing it to be true There is also the doctrine that certain trades have an inalienable right to particular kinds of work The unions insist that these vested interests shall be respected by all other unions Too the fact that some trades receive a lower rate of pay than do others develops a fear that unless the union insists upon its jurisdictional rights the employer will attempt to divert work from the higher paid unions to those receiving lower wage rates Finally there is the belief that the granting of small concessions leads to the granting of larger and larger concessions until ultimately the conceding craft loses its identity as did the copper smiths during the World War

Industrial Unionism

An industrial union is a labor organization which extends membership to all workers employed in a given industry regardless of the tasks at which they are employed or the degrees of skill which they possess The Amalgamated Association of Street and Electric Railway Employees illustrates the inclusiveness of this form of unionism It claims jurisdiction over the following employees of the tramway industry Motormen, conductors guards brakemen trolleymen, street railway bus operators employed in connection with the operation of street railways all men operating cars or trains, all gatemen, watchmen, wardens all employees of the car houses pit departments and track departments all collectors, janitors yard crews elevator men porters clerks and laborers [2] Thus the privilege of affiliation

[2] U S Bureau of Labor Statistics Bulletin 420 p 82

is offered to men of varying degrees of skill working at many different occupations The same breadth of membership is to be found in the United Automobile Workers Union The United Mine Workers The Amalgamated Clothing Workers Union, and the International Ladies Garment Workers Union

The primary unit of organization in an industrial union is the local Unlike the method followed in craft unionism the local of an industrial union bases its jurisdictional claims upon an industrial geographic area rather than the craft unit Thus all the employees of the automobile industry in say South Bend would hold membership in the Automobile Workers Union of that city However in those cities such as Detroit where a single local would have such a huge membership as to make efficient administration impossible several locals would be created within that area If there should be several automobile plants within the area covered by any single local the usual procedure is to constitute each plant a minor administrative unit Each administrative unit is headed by a union official bearing the title of Shop Steward His duties are limited to that of treating those matters which directly pertain to his individual plant, and his decisions are subject to the approval of the local

The various locals of any given industrial union are banded together in a national industrial union Thus the locals of automobile workers in the various automobile producing areas of the country hold membership in the National Automobile Workers Union The men who mine coal in the many coal producing areas of the United States are joined together through their locals into a national union—The United Mine Workers

The officers of a national industrial union are elected in conventions which are held either annually or biannually Representation in these conventions is based upon the numerical size of the local Although in theory any member of a local is eligible to stand as a candidate to represent his local at the convention in practice the election customarily goes to one of the officials of the local This is to be expected for the average member has neither the time, training inclination or money to accept the honor if bestowed upon him As in the case of some craft unions there is a tendency for the national officers to perpetuate themselves in office They are in a very advantageous position to build up, if not a political machine at least a strong support through the locals Mr John Lewis has been president of the United Mine Workers for many years and it would be a difficult feat to turn him out of office

Midway between the local industrial unions and the national industrial unions is another industrial union administrative unit the district industrial union These are based like the locals, upon a geographic area an industrial geographic area not necessarily coextensive with any political area To illustrate a coal field may encompass part of two states and contain many independent producers There are occasions when concerted

action by all the locals against all the producers within the area is deemed advisable The district industrial union is the medium through which such action takes place It is not a superior body in a political sense but an administrative means of accomplishing certain specific ends

Advantages of Industrial Unionism

It is claimed by the proponents of industrial unionism that it is the only form of labor organization capable of meeting the vicissitudes of modern technology Tasks in which the older craftsmen excelled are being and have been reduced to a series of simple routine operations Hence a labor organization which determines membership upon the bases of proficiency at some trade excludes all but a minuscule part of the workers of industry If unionism is to be extended so as to encompass the bulk of industrial workers especially those engaged in the mass production industries the outmoded rules of admission perpetuated by craft unionism must be discarded and the gates to unionism thrown open wide to all who would enter Industrial unionism, by offering a haven to all workers regardless of skill occupation or trade is held by its advocates to be the only form of organization capable of meeting the exigencies of the situation

There is too the claim that in numbers there is strength A grievance of any one or any group of employees becomes the grievance of thousands of other employees The knowledge that there stands behind any single member of the union the entire labor force of an industry develops a confidence in and an assurance of the strength of the labor organization The union increases its bargaining position because it can force the employer to choose between granting the demands or losing his *entire* labor force The mere numbers involved in a walkout by an industrial union make the problem of replacement exceedingly difficult Nor should it be forgotten that included among this vast number are many skilled workers

A corollary of the above is the necessity of establishing a common front against employers associations Since the employers in many of the larger industries have their own organizations covering a complete industry it is felt that the only effective means of negotiating with this body is to create a counter body of as great coverage A union of all the workers within an industry minimizes the possibility of an employers association ganging up on a single union in a single plant finishing it off and then moving into another plant and repeating the technique until in the end unionism would be eliminated from the entire industry

The industrial form of unionism develops a greater sense of the solidarity of labor It hasn't been unknown for the members of one craft union to supplant the members of another craft union who were on strike This happened when the locomotive firemen replaced the locomotive engineers and thus vitiated the withdrawal of the engineers In some cases an employer has defeated a craft union by "putting out their work to another

employer while continuing to employ the members of the other non striking unions to complete the job Industrial unionism by marshalling the entire working force of an industry under a single banner, makes it impossible for the employer to play one group against another

Finally jurisdictional disputes which have lived to plague workers, employers and the public alike will have less reason to exist under industrial unionism Industrial unionism by abandoning the basis upon which craft unionism rests uproots the very cause of jurisdictional disputes No longer will the unionist s prime interest be centered in the preservation of his narrow craft but a greater interest—the unity of all workers within an industry—will arise

Disadvantages of Industrial Unionism

Care must be exercised in considering the disadvantages of the industrial form of unionism Weaknesses which are common to all newly organized unions whether they be craft or industrial are apt to be confused with weaknesses incident to structural form Since many industrial unions are of recent birth fathered by the newly created Congress of Industrial Organizations it is to be expected that they should suffer all the ills of infancy And so they have But the ills of newness are not necessarily the ills of bad structural form

There is an inherent weakness in industrial unionism that may ultimately threaten its stability Carefully trained skilled craftsmen may never develop a true sense of oneness with the mass of unskilled workmen with whom they are called upon to unite They may always suspect that their best interests are being sacrificed to those of the mass of workers and if they should feel this keenly they constitute a potential disrupting force within the union Many of the elections conducted under the auspices of the National Labor Relations Board attest to the presence of this feeling Frequently the skilled workmen have given evidence by vote that they had no desire to affiliate with the non skilled workers within a plant

There are also technical difficulties incident to the determination of wage rates which must be faced by an industrial union The disparity of skill required in the innumerable occupations covered by an industrial union necessitates many separate wage agreements if wage rates are to bear some relationship to the worker s productivity To achieve a system of rates without engendering an attitude among some groups of workmen that they have been sacrificed for other groups calls for the highest type of administrative skill To circumvent the possibility of this situation arising, recourse may be had to the expedient of demanding a percentage increase in wages for all workers within the industry If this vertical increase in wages should be insisted upon by the union, it is conceivable that because of the cost price relationship in the industry the employer may not be able to grant the concession without either increasing the price of

his goods or substituting machines for men wherever possible Fearing that the first of these alternatives will badly disrupt his market he mav elect to fight the union If he on the contrary should choose the second course, some employees are faced with technological unemployment

The ability of industrial unions to withdraw workers in the mass is not an unadulterated advantage Mass withdrawals call for mass support which in turn necessitates huge defense funds An attack upon a great industry is incidentally an attack upon a vast resource of wealth which often is capable of withstanding a prolonged siege And finally mass with drawals especially if the degree of skill among those walking out is low require the prevention of other low skilled workers from walking in if the strike is to be successful Since an industrial union isn t in a position to establish a monopoly over all low skilled workers it must seek to persuade other workers from accepting the jobs vacated It is not a far step from peaceful persuasion to forceful mass picketing and from that to violence

Labor Unions

A labor union is the broadest of all types of labor organizations It offers membership to any and all wage earners regardless of their occupation skill training or the industry in which they are employed Cohesiveness among this polyglot mass is achieved by emphasizing the solidarity of the laboring group and the brotherhood of man especially the laboring man The One Big Union of Western Canada is the best existing example of this form of labor organization In the United States the Industrial Workers of the World though claiming to be an industrial union is the closest approximation of this type of unionization For purposes of illustration however the now defunct Noble Order of the Knights of Labor will herein be used

The Noble Order of the Knights of Labor was formed in 1869 in Phila delphia among the garment workers of that city By 1886 it had a mem bership of 700 000 and was the most powerful labor organization in the world at that time It was a national labor organization which transcended all occupations and industries, and welcomed within its ranks not only all workers—excepting preachers, bankers and bartenders—but even those who, although not wage earners, were sympathetic to its objectives

Although authority was centralized in a national assembly headed by a group of elected national officers the most important administrative units in the Knights of Labor were the local assemblies In some instances these local assemblies were local craft unions while in others they were indus- trial unions It was the hope of the national organization that an assembly of all workers could be organized within each ward of every city These local assemblies were united into district assemblies Above the district assemblies was the national assembly which wielded autocratic power In short, the Knights of Labor sought to create one big union with final

authority vested in a national body of officers, who were to exercise their authoritative powers for the betterment of all workmen

The Knights of Labor sought to achieve their ends, in theory at least through influencing legislation and by the use of the boycott Strikes in spite of the fact that they did occur, were looked upon with disfavor and used only as a last resort and then with reluctance It is true that as the more idealistic leaders were pushed aside by men of a more practical turn of mind the strike moved into a more prominent place in the arsenal of the Knights And although concessions were made to these men of direct action the national officers though at times strikingly indecisive as to which course to follow continued to adhere to the policy of progress through legislation and education

By 1890 the star of the Knights of Labor was in its de cendancy Ten years later it was no longer to be seen in the labor sky The disintegration of the Knights once it had started was swift and complete The debacle of this organization which once boasted a membership of 700 000 is traceable to several causes Its leadership steeped in idealism, was never quite sure of what its immediate wants were, nor did it seem certain of the particular means it would employ to achieve any end that had been decided upon Its reliance upon political action ofttimes netted the organ ization nothing more than bitter internal strife Its conception of the labor struggle as a fight against the money powers rather than against specific employers confused many an issue The heterogeneity of its membership made disaffection among them inescapable But important as were these causes the death blow was dealt by those skilled craftsmen who came to realize that their interests could best be served by creating autonomous unions of their own crafts The separation of these groups not only under mined the support upon which the Knights rested but led to the establish ment of a rival organization—The American Federation of Labor

The American Federation of Labor

The restiveness of the skilled workers under the domination of the Knights of Labor was kept alive by feeding on what was believed to be the impolitic and unbusinesslike policies of that organization Samuel Gompers like a voice crying in the wilderness, proclaimed that the destiny of the skilled craftsman lay in his eschewing that will o the wisp social reform and accepting in its place business unionism based upon the autonomy of the individual craft Making his obeisance to the lofty ideal of the ulti mate abolition of the wage system,' he, practical minded man that he was emphasized that in this work a day world in which workers toil they must advance toward it [the ultimate ideal] through practical steps, taken with intelligent regard for pressing needs His plea bore fruit In 1881 was established the precursor of the American Federation of Labor the Federation of Organized Trades Five years later in Pittsburgh, this

organization dropped its original title assumed more permanent form and evolved from the meeting the American Federation of Labor

The American Federation of Labor is a confederation of unions Workers do not hold membership in this association directly but indirectly by virtue of their membership in an affiliated union The bed rock upon which the American Federation of Labor rests is the 100 national craft unions which hold membership Although the primary interest of the Federation has been the perpetuation of the craft form of labor organization it has welcomed into its fold industrial unions such as the United Mine Workers [3] It is true also that in chartering Federal Labor Unions—locals of mixed membership directly affiliated with the A F of L—the Federation has not strictly adhered to the principle of craft unionism Too it makes concessions to the more inclusive forms of organization when it sanctions the formation of departments—those administrative organs created for the purpose of coordinating the activities of several craft unions within a given industry such as the building trades or the metal trades

The administrative organization of the American Federation of Labor is as follows [4] Conventions of the organization are held annually National unions state federations city centrals and the 4 departments of the A F of L all send representatives However since each of the state federations each of the city centrals and each of the 4 departments is permitted but one representative and one vote at the convention while the nationals are granted one vote for each 100 members [5] or major fraction thereof roughly 98% of the voting power resides with the national unions This assures their dominance of the convention The convention elects the Executive Council of the A F of L It is the function of this Council to conduct the business of the organization in the interim between conventions Because of its strategic situation the Executive Council has not only been able to perpetuate its personnel but through its power of committee appointments it has succeeded in establishing and enforcing definite policies even though the Federation itself is but a confederation of autonomous national unions

The American Federation of Labor has also created minor administrative units In order that independent locals within a city could cooperate on matters of mutual concern City Centrals were formed The various locals within the city send representatives to these bodies without sacrificing their autonomy And just as the City Centrals are formed for the purpose of facilitating cooperative action among the locals of a city State

[3] At present this union has left the A.F of L to join the C I O

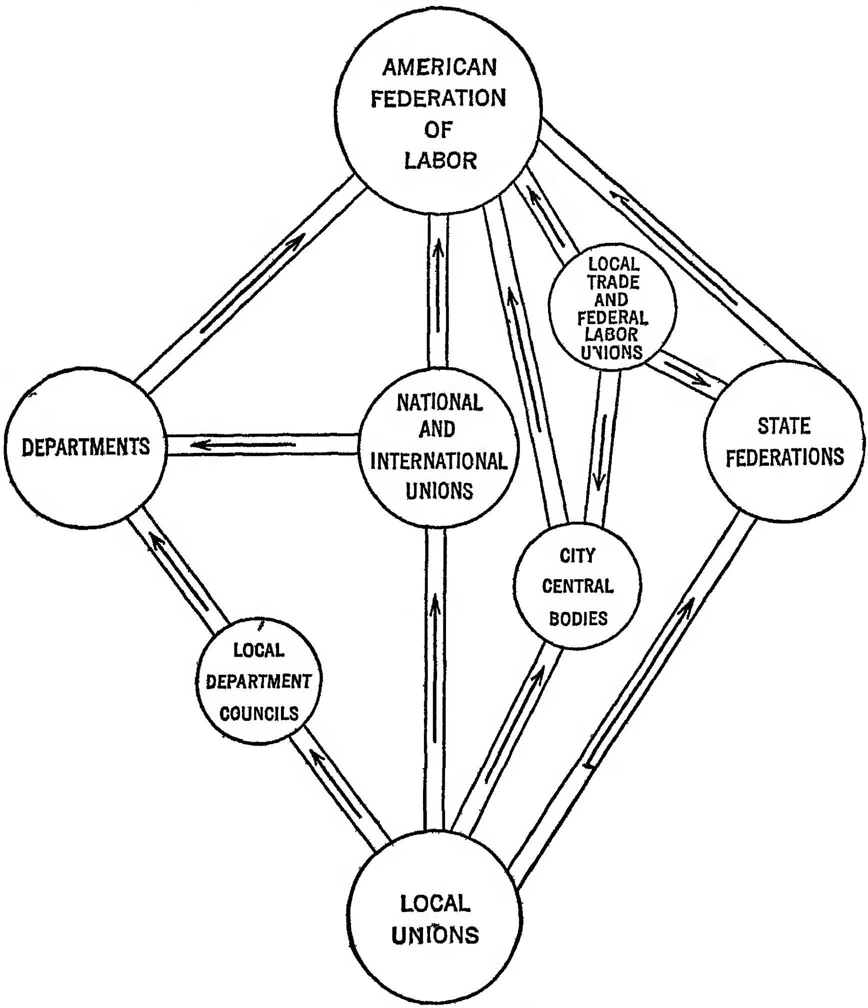
[4] See the chart on page 528

[5] Membership for purposes of representation at the convention is computed on the basis of the A.F of L dues paying (one cent per member per month) membership of the various nationals

Federations are their counterpart based however on a larger geographical area which is the state The Departments of the A F of L were set up to assist independent craft unions to achieve action in concert in those industries in which they had a common interest Thus in the building trades,

CHART 6

ORGANIZATION OF THE AMERICAN FEDERATION OF LABOR



the carpenters the masons the plumbers and so forth could act against their common employer in unison through the medium of the Building Trades Department

The cardinal objective of the A F of L is to assure the continuance of the craft form of organization as the dominant type of labor organization Fundamentally the Federation is a league of national craft unions

organized to preserve its constituents against the encroachment of competing forms of unionization The A F of L has fought dualism [6] without cessation In those cases where federal unions have been organized it has been the intention of the Federation that ultimately these locals will be combined into a national union The Federation has used its good offices unfortunately without startling success to settle jurisdictional disputes amicably It strives to secure the passage of legislation favorable to the cause of labor particularly to the cause of skilled labor Advocate as it is of business unionism an euphemism for that old Yankee practice of striking as shrewd a bargain as one can without losing his status as a respected citizen of the community the Federation encouraged its members to accept collective bargaining as the standard device for improving the conditions of labor Influenced by Samuel Gompers and William Green the A F of L has striven without respite to keep its policies free of the tinge of radicalism it has directed its endeavors so as to assist its constituent national unions to secure more and more for their members within the framework of the existing economic system

Section 7a of the N I R A

During the dark days of 1933 when confusion mothered dark despair the government in response to the request of organized business enacted the National Industrial Recovery act Section 7a of the act which incidentally was not greeted with unrestrained enthusiasm by some sponsors of the act affirmed in a positive manner rights long claimed by labor This section stated (1) That employees shall have the right to organize and bargain collectively through representatives of their own choosing and shall be free from the interference restraint, or coercion of employers of labor or their agents (2) that no employee and no one seeking employment shall be required as a condition of employment to join any company union or to refrain from joining organizing or assisting a labor organization of his own choosing, (3) and that employers shall comply with the maximum hours of labor, minimum rates of pay, and other conditions of employment, approved or prescribed by the President

Reaction to this legislation was immediate Workers in the mass production industries a field of endeavor which the A F of L had previously avoided, proceeded to organize on a grand scale The Federation cognizant of the impracticability of organizing the automobile rubber cement or electrical appliance industries along craft union lines established a series of industrial federal unions This wave of unionism which engulfed the mass production industries carried on its crest a demand for the creation of national industrial unions within each of these industries

This demand brought into the open a conflict that lay hidden within the

[6] Dualism is the setting up of a rival union which claims jurisdiction over a group of workers already holding membership in a union affiliated with the A F of L

membership of the A F of L The national craft unions with customary avidity sought to keep the way open to craft union membership for the skilled workers within these mass production industries They hesitated to make concessions fearing that concessions meant the ultimate loss of this field to craft unionism In contrast, another group of constituent members of the Federation viewed with approval the extension of the industrial form of organization Compromise marked the Federation s San Francisco convention in 1934 but like most compromises it was satisfactory to neither group and only succeeded in postponing the final break for a very short time

Mr T B Macaulay in Southey s *Colloquies* wrote that "men are never so likely to settle a question rightly as when they discuss it freely " But this was before Mr John L Lewis dramatized the conflict by hanging a hay maker on the chin of Mr W L Hutchinson of the Carpenter s Union at the Atlantic City convention of the Federation in 1935 On November 10 1935 the breach was widened when a group of national industrial unions and one federated craft union all affiliated with the Federation set up the Committee for Industrial Organization under the leadership of Mr Lewis [7]

The Congress of Industrial Organizations

On August 5 1936 the Executive Council of the A F of L ordered the Committee for Industrial Organization to disband When the Committee ignored the order and persisted in its work the Federation expelled those national unions which were backing the Committee on the grounds that they were fostering dualism Now that the final break had been made the Committee for Industrial Organization assumed permanent form and, later changed its title to the Congress of Industrial Organizations

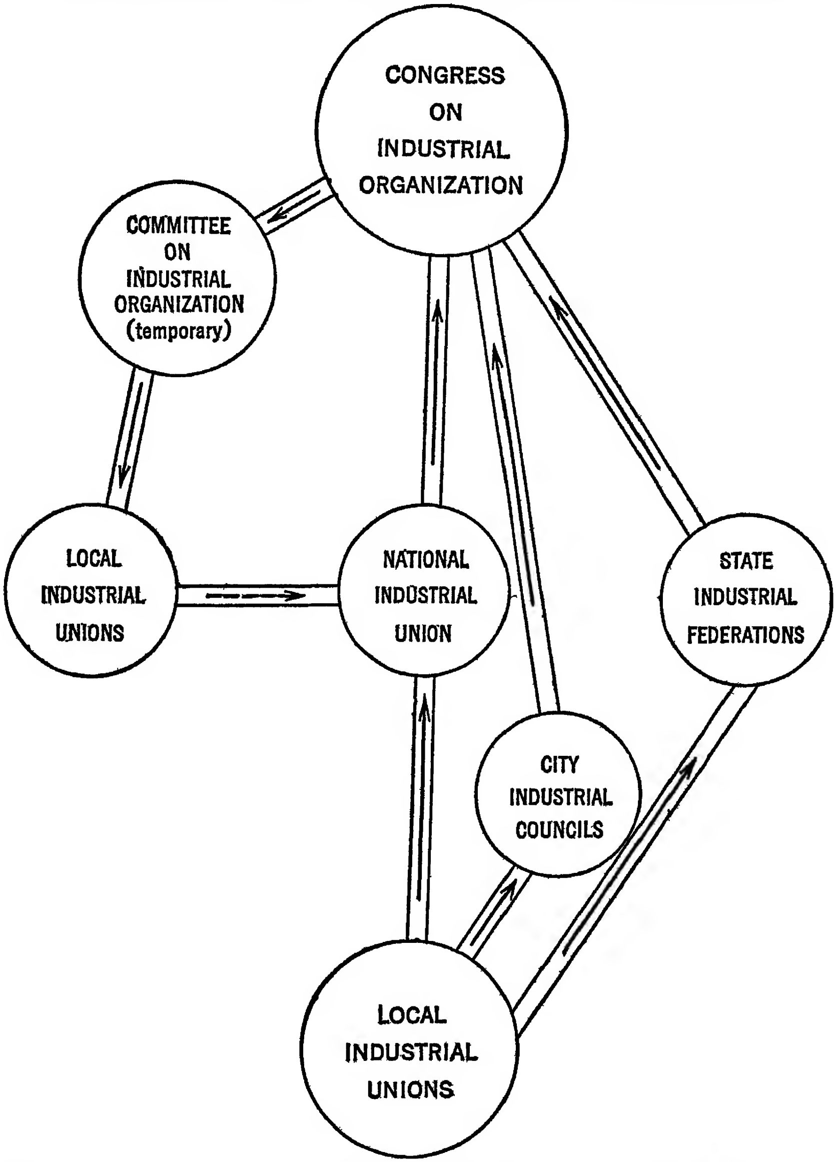
The administrative organization of the Congress of Industrial Organization is as follows [8] The national officers are a president secretary treasurer and an executive council The executive council a rather large body, is composed of the presidents of the constituent national industrial unions The executive officers (the president, secretary and treasurer) are elected yearly at the annual conventions of the Congress Representation at the conventions is based upon the membership of the constituent national unions The city industrial councils corresponding to the city centrals of the Federation and the state industrial federations analogous to the state federations of the A F of L, are granted one vote each much in the nature of a courtesy vote There is also a national committee known as the Committee on Industrial Organization The function of this committee is to organize national industrial unions in those industries as yet unorganized Basically this is a temporary committee for as it succeeds in its purpose its reason for continuing ceases to exist In those cities where

[7] At present Mr Philip Murray is president of the Congress of Industrial Organizations
[8] See page 531

the Federation s City Central offered hostility to the newly formed organ ization, rival organizations called City Industrial Councils were created

CHART 7

ORGANIZATION OF THE CONGRESS ON INDUSTRIAL ORGANIZATION



When hostility appeared in the State Federation, the Congress set up a State Industrial Federation

The C I O has as its primary objective the organization of the workers in the mass production industries in industrial unions for the purpose of

improving the labor contract of the members It holds that its policy is nothing more than an adjustment in the labor movement to the technological changes which have been occurring in American industry To insist upon the craft form of organization is but blind attachment to an outmoded symbol

The C I O has been subject to severe criticism Its opponents both within and without the labor movement have hurled accusations at the organization with an abandonment that bespeaks an unmitigated hatred Charity has not tempered criticism The C I O has been held the haven of all radicals the advocate of violence the destroyer of the labor movement An array which to say the least is imposing It is true that many of the newly formed unions in their quest for experienced organizers turned to radical political groups to find those whom they sought Communism is not however to be found in the top leadership and the role it played is more apt to be overemphasized than underplayed Violence there was but violence is rather an attribute of *new undisciplined* unions than an inherent characteristic of this form of organization And in speaking of violence there have been occasions when it has been instigated by employers rather than workers The theory that the C I O bestowed the kiss of Judas upon the cheek of Labor is playing lightly with the facts The schism is the result of stubborn insistence from both sides the determined refusal to make concession and not the least among the adamant disciples are to be found among the hierarchy of the American Federation of Labor If unity cannot be reestablished Labor faces a long internecine war which in the end may render it impotent against its common opponent

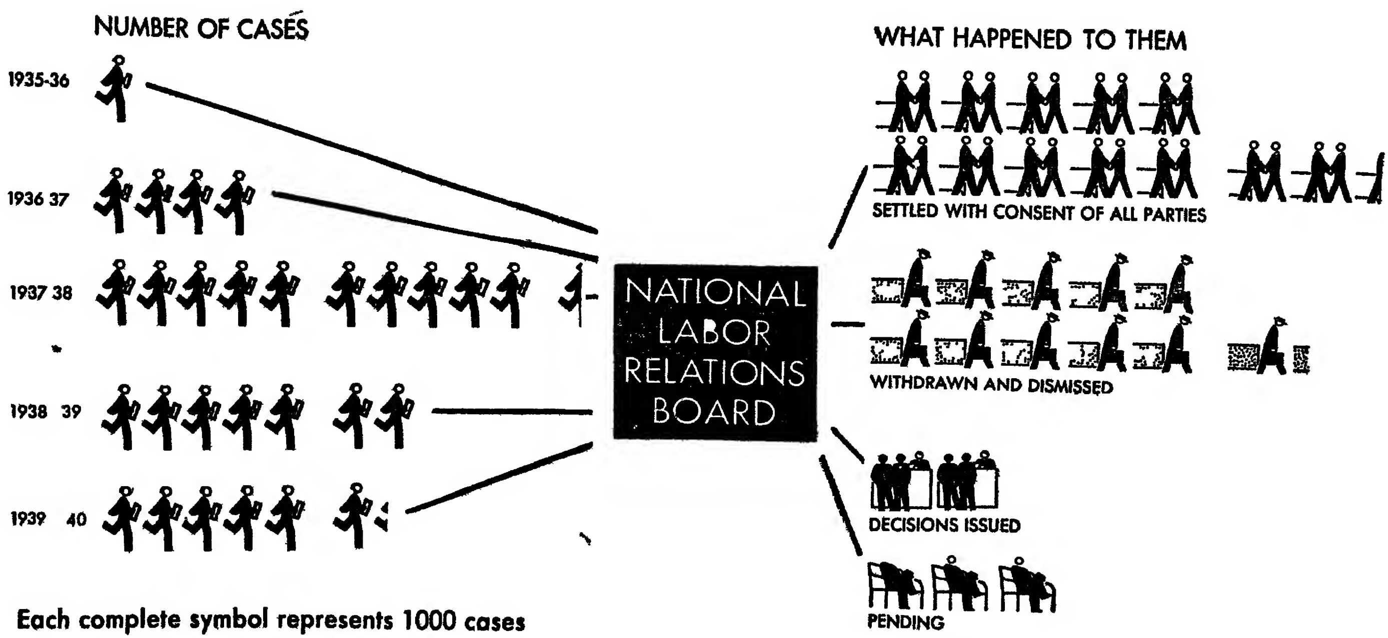
Unions of Their Own Choosing

This struggle of Labor to create unions of its own choosing has not been without opposition At one time the law held such organizations to be conspiracies in restraint of trade inimicable to the common weal, and hence forbidden But this was many years ago After the workers had established their legal right to organize their activities continued to remain subject to court review Often the courts made the unions ineffectual by denying them the use of the only available means for making their demands respected—strikes boycotts, etc Within some unions there were forces at work which drove prospective members away Strong arm squads have retained racketeers in power and through intimidation have made it possible for these vampires to wax fat on the blood sucked from the members [9] But the most effective opposition came from organized employers that form known as Anti unionism

Anti unionism has taken many forms some of which tragically enough testify only too well to the fact that some few employers will still ' stoop to

[9] Today a bitter fight is being waged within the ranks of labor to rid itself of this blight

DISPOSITION OF ALL CASES



Each complete symbol represents 1000 cases

[From National Labor Relations Board By permission of Pictograph Corporation]

conquer '[10] Many reasons ranging from hate and fear of Reds to a crystal clear recognition of economic self interest have been advanced in support of this anti union position One technique is to eliminate the incentive to organize This is accomplished by maintaining working conditions at so high a level as to make them the envy of unionized plants This type of pro gram is usually complemented by welfare activities which often include visiting nurses comfortable reading rooms uniformed baseball teams glee clubs and candy for the kiddies The cost of such programs may be held small if they succeed in permitting a man to run his business in his own way

Opposition has however, taken more positive forms Company unions have been created in the hope that they will counteract any desire for real labor organizations[11] Unionists object to company unions in that the mere bringing together of the workmen of a plant in an organization which is dominated by an employer is not a union but merely a clever device to defeat unionism Some employers have found the hiring of labor spies advantageous These gentlemen are paid and usually very well to gain the confidence of workmen, learn of their plans and attitudes so that the employer can be informed of those he had best separate On occasions strong arm squads have been used to beat up union organizers Brass knuckles lead pipe and tear gas have often been found useful by these gorillas A more subtle method was that of having the worker sign a ' yellow dog contract a contract in which he agrees never to join a union while in the employ of the contracting company The contract was en forced by securing an injunction against anyone who attempted to ap proach the worker as a union prospect In 1932 this technique was out lawed by the Norris LaGuardia Anti injunction Act which held that (a) injunctions cannot be issued to stop unionization of workers who have signed yellow dog ' contracts and (b) no injunction could be given to stop picketing

In 1935 with the passage of the Wagner Labor Relations Act Labor felt that it had at last reached the end of the road leading to unions of its own choosing The law grants in a positive fashion the right of collective bar gaining through elected representatives of the workers' own choosing The law is made effective by enumerating a series of what are termed ' unfair labor practices ' all of which are prohibited Thus refusal by an employer to treat with the elected representatives of his workmen constitutes an unfair practice If there should be uncertainty as to just who are the true representatives of the workers an election is held under the super

[10] See La Foll tte Committee Hearings before a Subcommittee of the Committee on Education and Labor United States Senate 74th Congress pursuant to S Res 266 Parts I II III

[11] A company union is an organization sponsored by the employer consisting of his employees only which is created for the purpose of settling matters pertaining to the labor contract

vision of the Board and the results settle the issue Too, a company union initiated or financed by an employer is specifically held not a proper instrument for collective bargaining and is barred from participation in elections unless its rules are changed so as to give the employee a real voice in its affairs The administration of the act is lodged in the National Labor Relations Board a body consisting of three members selected for their competence and impartiality

Labor has traveled a long hard road Opposition has been bitter and determined and at times has exhibited a Mephistophelian cunning It has suffered on occasions from its own short sightedness as well as from the avarice of some of its officials Yet in spite of its mistakes its stupidities it has at last achieved the right to seek its destiny in organizations of its own choosing

CHAPTER 33

FORMS OF TRADE UNION PRESSURE

Labor to achieve its ends is constantly seeking new weapons of pressure as well as attempting to perfect those already in use The union s strategy is to locate the most vulnerable spot in the employer s defense so that by concentrating an attack on this Achilles heel it may force him to concede its demands Workmen have come to realize often after bitter experience that if collective bargaining is to be effective the union must be capable of backing its demands with some form of pressure When the business unit was so small that employees could maintain a personal and intimate contact with their employer an appeal based upon this close relationship was often sufficient with the development of the business unit to huge proportions and the consequent loss of individuality by the laborer this method became impracticable Conscious of the weakness inherent in individual bargaining workers turned to collective action However if the workers committee when waiting upon the employer is to be a determining factor in collective bargaining it must be capable of something more than presenting a request it must control some form of pressure with which to enforce its demands

Limitation of Membership

Unions if they can limit the number of men capable of performing a certain type of craft are in a position to exact a monopoly price for the services of their members This technique of restricting supply so as to enhance value is not a practice unique to unionism Business has long known that gratuitous profits are to be had if competition can quietly be laid to rest And business has sought through favorable tariffs patent rights trade marks gentlemen s agreements combinations and various and sundry other arrangements to free itself from the restraining influence of competition This endeavor of unions to enhance the value of its product may well be called the business method of unionism

There are various means which a union can use to restrict the supply of skilled craftsmen Limiting the number of apprentices, one of the more favored techniques automatically decreases the quantity of workmen capable of filling skilled occupations Since there are more ways of killing a goose than stuffing it to death so there are more ways of limiting apprentices than arbitrarily fixing their number The apprenticeship period may be so prolonged that all but the most tenacious will give up in despair

Admission to the status of journeyman may be conditional upon the occurrence of vacancies in that class Initiation fees may be prohibitive These techniques are effective to the extent that exclusion from the union means exclusion from practicing the trade If the union should control but a fraction of the employees of an industry apprenticeship limitation will partially be offset by those opportunities to learn the trades which are available in non union shops However if the union be co extensive with the practice of the trade it is in a most strategic position to make effective its control over the supply of that particular type of skill

This practice is criticized just as monopoly practices in general are criticized because it results in an improper allocation of resources Fewer men than society requires are trained for particular tasks An artificial barrier obstructs the free movement of labor into various trades Since labor is a cost of production and since this practice decreases the supply of particular types of laborers prices tend to be higher than they otherwise would be Consumers consequently buy either fewer units of the affected good or reduce their purchase of other commodities Furthermore if one avenue of employment be closed to those seeking a trade, there results an overabundance of workers competing for jobs in other fields This depresses wages in these latter areas In short the objections raised against this policy are the objections raised against all forms of monopoly practice—they are anti social in that the supply is artificially limited so that some few can improve their lot at the expense of the many

The ability of unions to exercise this form of control has decreased with the passing of the older types of skill Unless an occupation requires some extended period of training it is relatively difficult to apply the policy The members of a union composed of low skilled workmen could hardly expect to enhance the value of their services through the use of a technique of this kind Their hope lies in collective bargaining for this does not depend for its effectiveness on a reduction in the numerical size of the union but rather upon the availability of pressure weapons

Restriction of Output

Workers view the future in terms of the jobs at which they are currently engaged The problem of employment is primarily that of keeping the jobs at which they are immediately employed as long as lies within their power The relationship which exists between labor costs and the price of the finished commodity does not ordinarily enter into their calculations The elasticity of the demand curve is a technical refinement of which they know little and what is more care less They reason from the specific they draw upon the storehouse of their own personal experiences for guidance They vividly remember that the completion of a task has on occasion ushered in a period of idleness a period which they believe in retrospect, could have been avoided had they worked less assiduously They may have

knowledge of situations where men, working at piece work rates, hoping to expand their incomes increased their output only to find that the rate was subsequently reduced It is very probable that their information is incomplete and, at times false but nonetheless, it suffices to reassure them in their conviction that since there is just so much work to be done the ' smart fellow does not hurry to work himself out of a job It would be erroneous to attribute to blind stupidity this desire to restrict output it is rather a policy that has developed out of the experiences admittedly individualized and limited of the workers

The means of implementing this policy take various forms Bricklayers refuse to lay over a fixed number of bricks per day painters refuse to use brushes which exceed a certain size, certain tools and machines are proscribed All these methods seek to achieve one common objective—to limit output

Despite the adage that ' to understand is to forgive,' the maxim is not of sufficient elasticity to permit one to condone this policy Restricting output increases costs not only do labor costs increase but since over head is now spread over fewer commodities fixed charges per unit of product advance Prices eventually rise with the result that less units of the goods are purchased The reduction in consumers purchases ad versely affects the demand for labor Thus society has fewer goods to enjoy it furthermore pays higher prices for those which are available and labor in seeing so clearly the immediate and the obvious, loses sight of the more distant and ultimate results

The frequently advanced defense of this policy rests upon the need of protecting the health of the worker It is sometimes claimed that pro duction quotas are set which force workmen to produce at a 'killing pace' The union maintains that to soldier on the job or to establish maxima of performance protects the worker against the devastating effects of accumulative fatigue This argument is very probably badly over worked Modern industry with a decreasing number of exceptions is more and more endeavoring to create healthful, sanitary and pleasant condi tions of employment It has learned that contented workmen are productive workmen

The Closed Shop

If a union should establish a monopoly over the labor force it is in a most advantageous position to secure uniform conditions of employ ment The technique used to attain this end is the closed shop The closed shop may be one of two types the closed shop with the open union that is, a shop in which employment is open to anyone provided that he accepts union membership as a condition of employment, the other type is the closed shop with a closed union, that is, a shop in which employment is restricted to men already holding membership in the union

The closed shop policy has been subject to severe criticism The claim is sometimes made that it interferes with that fundamental right of every man or woman to work for whomever he pleases and that inalienable right of every employer to hire whomever he chooses This accusation is customarily accompanied by an advocacy of the open shop In theory the open shop policy offers employment to anyone regardless of whether he be a union member or not To many this appears eminently fair In practice however the open shop is generally an anti union shop in spite of protests to the contrary So while in theory all are welcomed within the gates in practice all *but* union members are so welcomed Even though practice were to adhere more closely to theory and unionists were accepted the resultant lack of uniformity in the conditions of employment would make unionization meaningless

The reasons advanced by the proponents of the closed shop however do not customarily emphasize the need of uniformity but rather stress the moral obligation which falls upon every worker to share in defraying the costs incurred in securing improved conditions of employment This may be conceived of as the moral justification of the union s position actually however this is not the 'real' reason despite its popular appeal If a union is to control the personnel of the working group if it is to secure uniform conditions of employment if it is to create a sense of solidarity within the group then the closed shop offers the most feasible means of achieving these objectives If the union can limit the number of men moving into a trade through the establishment of a closed shop with a closed union it also enhances its opportunity of exacting a monopoly price for the services of its members

The Standard Rate

The standard rate, whether it be stated in piece or hourly terms, is that minimum amount uniform in its application which is set by a union as a just compensation for the performance of particular types of work by definite classes of workmen [1] More fundamentally however the standard rate is a union device to facilitate collective bargaining by substituting uniformity for variations in hours and wage rates The union hesitates to sanction a variety of rates for the same type of work, lest in so doing it court disaster Collective bargaining by its very nature necessitates reducing dissimilarities in hours and wages to easily understood uniformities If the union should endeavor to negotiate a special bargain for each of its particular members the program would soon bog down in a morass of administrative detail On the other hand, if each workman were permitted to bargain individually, collective bargaining would cease to exist Ultimately, if this were attempted, competition among the workers

[1] The standard rate is customarily conceived of as a union device, however a standard rate *may* be set by the company

would be intensified rate undercutting would result and wages would fall The union by insisting that no member shall accept employment under the standard rate creates a floor below which wages cannot be driven, at least by the competitive action of the union s members

By its critics the standard rate has been labeled an example of un American regimentation which exacts a penalty from the more efficient members of the laboring force The inference which is often drawn is that the standard rate denies the employer the opportunity of adequately compensating superior ability It should not be forgotten that the standard rate is a minimum and not a maximum rate If superior ability be present, the employer is not prohibited from paying these more capable workers a rate in excess of the minimum The union s objective in fighting for the standard rate is twofold to facilitate collective bargaining by creating uniform conditions of employment and to prevent competitive undercutting of wages

The determination of the particular point at which the rate should be established involves the making of a nice decision If the rate be set too high the probable result would be the separation of those less efficient workmen whose value product falls below the established rate If on the contrary the minimum rate be set too low widespread dissatisfaction with the agreement is apt to play havoc with the union The problem then, is to find that rate which while insuring the worker an adequate acceptable minimum will not at the same time cause a separation of workmen from jobs The Typographical Union has sought to solve this problem by establishing sub classes for the less efficient employees among the various occupations Each sub class has its own, special rate lower than the fixed minimum for that particular class of workmen Thus the least efficient by being placed in a lower rate classification can continue to find employment This endeavor is a frank recognition by the union of the relationship which exists between productivity and recompense, as well as an attempt to solve the problem to the satisfaction of all concerned.

Collective Bargaining

Collective bargaining is the antithesis of individual bargaining It is the refuge of men disillusioned with the results of individual action in the market in which they sell their services It exists when workers, acting in concert through representatives of their own choosing consummate a trade agreement [2] with their employer relative to the conditions of em-

[2] The following is from a trade agreement entered into by the International Association of Machinists

Section 3 Eight hours shall be the standard work day except on Saturday when work shall cease at 12 o clock noon

Where night shifts are worked not more than 40 hours per week shall be worked in five shifts

ployment The agreement once reached is binding upon both parties to its creation for some specific period of time While the immediate object of such *trade agreements* is the improvement of the labor contract there is usually established a means of settling subsequent differences between employer and employees without recourse to strikes or lockouts Collective bargaining assumes both the existence of a union and its recognition by the employer In a sense therefore collective bargaining is the culmination of collective action

The representatives chosen by the employees to wait upon the employer may be selected from among fellow workmen who are still working at the bench' or they may be outsiders that is officials of the union trained for just such work Employers are usually more reluctant to treat with these outsiders than they are with representatives chosen from among their own employees This resentment of what at times is referred to as outside interference by persons unfamiliar with plant conditions is often nothing more than a thinly veiled admission of the greater competence possessed by these trained negotiators Even though competent representation facilitates the achieving of a more acceptable labor contract, in the last analysis the union s effectiveness in bargaining depends upon the weapons which it can muster to enforce its demands

The *positive* affirmation of the worker s right to engage in collective bargaining set forth in Section 7a of the National Industrial Recovery Act fell when that Act was invalidated by the Supreme Court in 1935[3] In the same year however the principle was reaffirmed when the National Labor Relations Act became part of the substantive law of the land The Act stated that Employees shall have the right to self organization to form join or assist labor organizations to bargain collectively through representatives of their own choosing and to engage in concerted activities for the purpose of collective bargaining or other mutual aid or assistance In addition to this positive affirmation the law enumerates a series of

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Men employed on night shifts shall receive the same compensation for 40 hours as they would receive for 44 hours on day shift

Section 4 Double time shall be paid for all time worked over the regular day and night schedule and for Sundays and legal holidays

No overtime shall be worked on nights when shop meetings are to be held

In case of depression in trade the hours shall be shortened all that is necessary to keep the normal force employed

Section 5 Apprentices shall not be less than 16 and not over 21 years of age at the beginning of their apprenticeship term

The number of apprentices shall not exceed one to every five journeymen machinists nor shall they be permitted to work overtime

Apprentices in their last year of service may be sent on outside jobs with journeymen machinists in the ratio of one to each job —From U S Bureau of Labor Statistics *Trade Agreements 1923 and 1924* Bulletin No 393 (1925) p 71 quoted in W H Kiekhofer *Economic Principles Problems and Policies* (D Appleton Century Company, New York 1936)

[3] On May 28 1935 in the Schechter Poultry case

'unfair labor practices' which if resorted to by an employer are held to be illegal abridgements of the workers rights and as such punishable under the law By designating acts which are unfair certain practical difficulties handicapping effective collective bargaining are removed The enforcement of the legislation resides in an administrative body consisting of 3 members known as the National Labor Relations Board

The Board is obligated to protect the worker from coercion when selecting the individuals and the organization which are to represent him in collective bargaining [4] In order that the will of the workers can be ascertained in an atmosphere free of intimidation elections are conducted under the supervision of the Board If at an open hearing before the Board it can be proved that the employer has directly or indirectly influenced the decisions of his workers not only is the election invalidated but the offending employer becomes subject to punishment [5]

The difficulty of distinguishing collective bargaining in form from collective bargaining in fact may be illustrated by the presentation of a situation which has arisen Assume that a company after negotiating with the workers committee reaches an understanding The company, however insists that a written agreement is unnecessary since it has indicated its assent orally The question which then is at issue is this Does collective bargaining to exist in fact require that all negotiations must culminate in written agreements? The union maintains that the absence of a written agreement removes the only practicable method of subsequently enforcing the terms agreed upon, disputes are inevitable for the content of the agreement is no longer a matter of fact admissible in a court of law but only one man s word against another s The employer argues that since he has met with his employees representatives, listened to their demands offered counter proposals and finally reached an oral agreement he has fulfilled his obligation as set forth in the law The National Labor Relations Board has held a written agreement to be a constituent element of collective bargaining and to this extent the position of the union has been upheld

The Board has held that collective bargaining implies more than a willingness on the part of the employer to meet with his employees If in the employer s opinion the demands of his workers appear unreasonable he must if collective bargaining is to exist, offer counter proposals Suppose

[4] The law states Representatives designated or selected for the purpose of collective bargaining by the majority of employees in a unit appropriate for such purposes shall be the exclusive representatives of all the employees in such unit for the purpose of collective bargaining in respect to rates of pay wages hours of employment or other conditions of employment Provided that any individual employee or a group of employees shall have the right at any time to present grievances to their employer

[5] This right was again upheld by the Supreme Court in the Serrick Co of Muncie Ind case November 12 1940

that the employees now working for 60¢ an hour should demand an increase in pay of 20¢ an hour The employer refuses, but offers as a counter proposal an advance of 3¢ an hour fully aware that this offer is not accept able Assume that he persists in meeting each new proposal with an un acceptable counter proposal in the hope that the negotiations will be pro longed indefinitely Does this constitute collective bargaining? The Board maintains that collective bargaining does not exist unless negotiations are entered into in good faith that is entered into with the intention of reaching an agreement within a reasonable length of time Good faith however is not something which can be stood against a yardstick and measured It is extremely difficult at times to determine when counter proposals are being made in good faith or are but clever artifices for subtly vitiating collective bargaining Specifically in the case present ed above what would constitute a counter proposal extended in 'good faith ?

Despite the numerous criticisms which have been leveled at both the Act and the Board to say nothing of the active and often bitter, opposi tion which each has had to face some progress has been made toward a more rational handling of the employer employee relationship Unfair labor practices ' have been defined with greater precision an administra tive body charged with the duty of securing compliance with the law has been established administrative techniques have been and are being per fected as experience enriches practice A time may be anticipated when collective bargaining conducted under the auspices of a wise and experi enced National Labor Relations Board will be marked by intelligent reasonableness on the part of both the employers and employees

The Strike

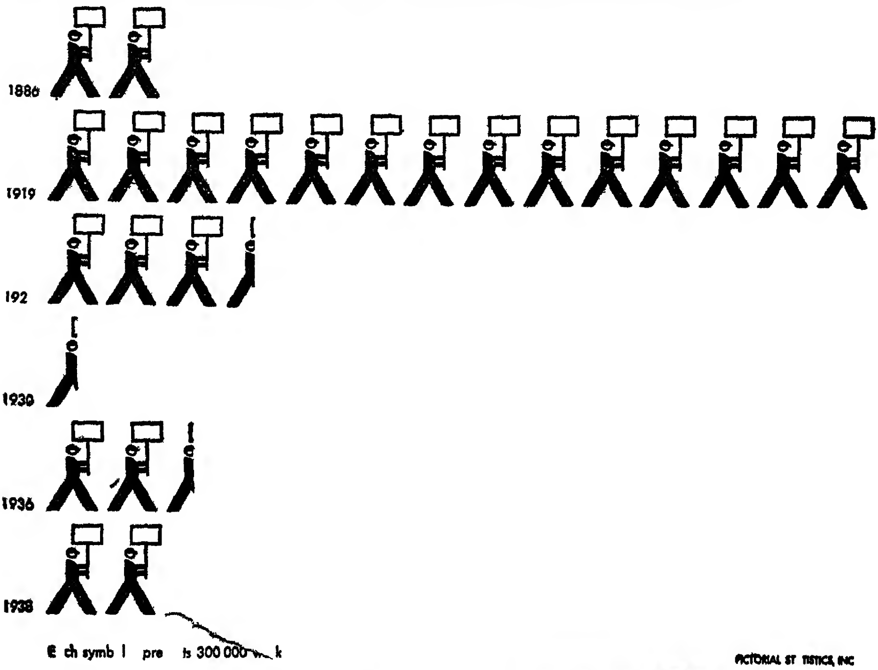
A strike is a temporary concerted withdrawal of employees from jobs for the purpose of enforcing demands which have been made upon an employer During the period of withdrawal measures are taken by the workers to retain the places which they have vacated Although the strikers walk out they continue to view the jobs which they have temporarily surrendered as their property It is this attitude which frequently accounts for the violence which often accompanies the use of strike breakers In brief, the strike is a pressure weapon which unions use to secure their ends when peaceful negotiation proves futile

There are some people who view strikes with repugnance They see them only as a wasteful, immoral resort to force One may be justified in suspecting the sincerity of some who profess advocacy of unionism but who at the same time profess their abhorrence of the strike At times such protestations are but pleas for ineffectual unionism Yet the costliness of labor disputes is not to be gainsaid In the aggregate the sum exacted is

staggering[6] Goods and services the life blood upon which the material well being of society feeds cease to flow Strikers lose their wages employers their profits The state may be subject to additional expense as it endeavors to maintain order One would be completely devoid of imagination if these losses did not set him thinking

To the seasoned unionists or a mature union a strike is not a thing to be entered into lightly nevertheless, it is too effective a weapon to be readily relinquished Many unions like many people acquire discretion

WORKERS INVOLVED IN STRIKES AND LOCKOUTS



[From Faulkner and Kepner *America Its History and People* (Harper and Brothers) By permission of Pictograph Corporation]

with age They frequently grow affluent with time benefit funds fructifying with the years develop into sums of enviable proportions Issues are weighed with care before a strike is permitted to jeopardize the union's accumulated savings It is no secret that a labor dispute especially if it should be prolonged, drains the union of funds Strike benefits must be paid so that families can be fed clothed and housed Lawyers must be retained and the inevitable court battles fought Public opinion must be wooed through newspaper and radio appeals New unions with little to

[6] The National Association of Manufacturers estimated that the cost of strikes in the United States between 1916 1923 a gregated $13 billion B Mitchell, *General Economics* (Henry Holt and Co New York 1937)

lose desirous of testing their mettle often display an aggressiveness that borders on rashness

One of the necessary elements in production is the maintenance of a competent and adequate labor supply The union through the use of a strike, endeavors to impair production by disorganizing this labor force If it can successfully withdraw the workers from the plant and prevent others from replacing them it has gone far in achieving its objective Ultimate success depends however upon the ability of the union to maintain a condition of this kind sufficiently long to threaten the profits of the employer Management is usually ready to settle the issues when it is financially advantageous to cease fighting This willingness to arbitrate may develop not only as a result of immediate loss but also because of fear that the business may be absorbed permanently by competitors Thus the union s attack is aimed directly at the company and at the motivating force of the enterprise—profits

The effectiveness of a union in controlling the supply of labor in an industry depends upon the degree of unionization within the trade and the degree of skill possessed by the members of the union If the organization is composed of highly skilled mechanics and is completely unionized it is in a most advantageous bargaining position In this situation it is practically impossible for the employer to replace the workers because of the relative scarcity of men competent to master the calling and who at the same time are not members of the union On the other hand if the employer needs only unskilled workers his chances of replacing them if they should walk out are much greater A union s bargaining position consequently depends greatly upon its effectiveness in preventing replacements from being made

Calling a strike involves more than the mere order to abandon the job It is necessary that the order be issued at a propitious time An inopportune decision may spell defeat before the first gun of battle has been fired Timing then is more than a word sired by the pen of sports writers out of the game of football This may be illustrated by a strike called many years ago—1902—in the anthracite coal fields This industry sells a commodity the demand for which exhibits marked seasonal variations. John Mitchell, the then president of the United Mine Workers appears to have been the single member of that organization who grasped the full significance of this matter of timing Because of limited space and high rentals the retail coal dealers in the larger urban centers did not continuously accept coal from the producers and store it in anticipation of the winter demand As a result the anthracite coal mined in the late spring and summer was stored at the mines to be shipped in the fall and winter [7] It was to the owners' advantage to reduce production as much as possible during the

[7] U S Department of Labor Bulletin 46 p 452

warm months Consequently a strike called in May would not seriously incommode the producers until the early fall when the retailers began to demand the commodity If the strike were declared in the summer four months would pass before the withdrawal became a menace to the em ployers During these months the strikers must be supported an expense which would tend to deplete the fullest defense fund morale must be maintained lest dissatisfaction break the common front and the will to resist be weakened techniques must be developed to prevent the em ployers from recruiting a new labor force The failure to recognize this matter of timing proved the undoing of the strikers in the anthracite strike of 1902 [8]

Electing to strike in the depression phase of a business cycle is usually inexcusably bad strategy The labor market is full to overflowing with unemployed workers Necessity may drive these unfortunates to accept any type of employment that is available Reluctance to replace men on strike may retreat before the temptation of a job and food for the family Too it is difficult to affect profits when they are non existent Business may be so depressed that an employer may welcome the opportunity of closing down his plant On the contrary when business once again im proves and profits reappear, employers are more willing and more able to make concessions They have no desire, when at long last the chances for profitable operation returns to see this opportunity done in by a strike The query is sometimes raised as to why should workmen walk out just when business is beginning to enjoy profits The union s answer is that one must strike when the iron is hot

Skilled craftsmen thoroughly unionized, find the prevention of their replacement when on strike a matter of relative ease The absence of non union craftsmen competent to master the tasks vacated leaves no one to whom the employer can turn A solitary *picket* leisurely sauntering before the offending plant suffices to warn off all unionists

When low skilled workers strike the problem becomes more compli cated The supply of this type of worker is comparatively great conse quently unions composed of unskilled members must implement their withdrawal by developing some means of preventing the employer from replacing them by tapping the seemingly redundant supply of untrained workers *Mass picketing* has been turned to in this search for an effective weapon An endless chain of pickets, like a noose encircles the plant The chain is not stationary as are the gold links around one s neck but moves unhurriedly This line must be penetrated if an adequate replacement force

[8] Mr Mitchell stated For my part I was still opposed to the declaration of the strike at this time (May) if it could possibly be avoided I foresaw that the conflict would be long and severe and I hoped it might be averted until the fall when the men would have struck more effectively Quoted in Elsie Gluck *John Mitchell* (The John Day Co New York 1929) p 103

is to be secured by the employer If the strike breakers should insist upon forcing the line they will be pleaded with taunted and if these means prove ineffectual physical force may be used to dissuade them from continuing in the error of their ways Although violence is at times instigated or encouraged by the employer [9] for the purpose of discrediting the union in the eyes of the public the reason for its frequent appearance in strikes conducted by unions composed of low skilled workers is more deep rooted Since the strikers are unable to rely upon a scarcity of their particular abilities to protect their jobs they turn to the only other means which they believe effective—physical force This may be the reason which explains the violence that has characterized some of the strikes in the mass production industries

The law does not countenance the use of violence in the course of a strike It also insists that the strike must be for the benefit of the strikers and not for the purpose of inflicting injury upon the employer As long as picketing is peaceful [10] it is held to be legal but if intimidation is resorted to it ceases to be peaceful and hence is illegal Unless certain actions, such as mass picketing the use of violence by pickets etc ,[11] are specifically designated by statute or court precedent as establishing the fact of intimidation the presiding judge is granted a considerable degree of latitude in reaching his decision Possibly it is the difficulty of determining precisely when intimidation has been used that accounts for the seemingly contradictory decisions rendered by the courts

Sit down Strikes

Restricted in their use of picketing the unions in the mass production industries have sought a more effective means of preventing the employer from recruiting a new labor force This search yielded the sit down strike The sit down strike or what is more accurate, the stay in strike is that technique whereby employees cease working yet do not vacate the plant It is a strike without a walkout As long as the workers cannot be evicted there is no practicable means available to the employer for continuing production

If the endeavor be made to remove the men by force violence is inevitable Injury and possibly death are inescapable The resisting strikers

[9] A method used by some employers is the hiring of professional strike breakers men who are often proved to be upon investigation of questionable character frequently with distinguished criminal records and not uncommonly recruited from the riffraff of our cities See L Levinson *I Break Strikes* (McBride Co , New York, 1935) The Federal government has made the interstate transportation of strike breakers an illegal act punishable at law

[10] In the Atchison Topeka and Santa Fe Railway vs Gee 139 Fed 582, Judge McPherson held peaceful picketing to be a contradiction in terms

[11] In American Steel Foundries Co vs Tri City Trades Council 257 U S 184 and in Truan vs Corrigan 257 U S 312 the Supreme Court declared mass picketing to be illegal but sanctioned the use of single pickets at the various entrances of a shop

may retaliate by destroying machinery and ruining materials It is these eventualities that make even the bitterest foes of the sit down strike hesitate before insisting that the state use force to remove the strikers

The sit down strike is a highly effective weapon and for that reason will probably be surrendered only under duress The technique, however, is not ordinarily evalued on the basis of its effectiveness as a pressure weapon but rather on the basis of its legality It is attacked because it constitutes an interference with property rights It is claimed that the competitive capitalistic system of America rests upon the perpetuation of the system of private property If this right be denied by permitting strikers to take over another s property then it is claimed a wedge has been driven into the system which ultimately will crack it wide open

The courts have held the sit down strike illegal on the grounds that it abridges property rights But property rights being man made are subject to modification and change Possibly the concept should be redefined perhaps it should be broadened to include the right of a worker in a job A man who has been employed at a task for a long number of years develops a sense of property right in that job, regardless of what his legal claims may be It is possible that as labor grows stronger politically the right of a worker to his job will be viewed as a property right

Sympathetic Strikes

The union frequently finds that a direct strike fails to prevent an employer from securing an adequate supply of labor and in this event other forms of pressure are brought to bear upon him Although the sympathetic strike is generally held by the courts to be illegal and it is fraught with numerous dangers, its use is held justifiable by organized labor [12] Back of the sympathetic strike is the belief that success can be more readily achieved if the withdrawal from work is extended to include unions other than the one directly concerned The pressure upon the offending employer will be increased if his workmen other than those already on strike, refuse to continue to work and if the walkout be carried into the industries from which he has been receiving his raw materials or to those enterprises to which he has been sending his finished commodities he may be subject to such loss that he will be willing to settle the dispute

Excluding its illegality, the weakness which inheres in the sympathetic strike is the difficulty of creating a feeling of oneness among a sufficiently wide group of unions A union, removed from the immediate conflict does

[12] There are times however when sympathetic strikes are not only justifiable but actually noble A wise sympathetic strike which involves no breach of contract and is of such a nature as directly and powerfully to influence the results of the original contest a strike carried out not for the immediate good of the members of the union but for that of other workmen *emphasizes* as no other event in industrial society the universal brotherhood and solidarity of labor —John Mitchell *Organized Labor* (American Book and Bible House Philadelphia 1903) p 304

not feel its interests sufficiently involved to justify its calling of a sympathetic strike A letter of encouragement a monetary contribution is the easier and less costly course to follow The building trades are an exception to this generalization These unions have developed an instrument of great power—the joint closed shop It is effective because the employer is compelled to deal with a combined labor force The bargaining position of an individual union say carpenters is improved for not only are its own members withdrawn in event of a strike but the walkout is extended automatically to all union laborers—masons plumbers etc engaged on the job

The Boycott

A boycott on commodities seeks to coerce the employer by denying him a market for his goods [13] Through it the union enforces its demands by restricting the market of employers in the purchase and sale of economic goods whether these goods be raw materials, materials in a partial state of completion or finished products about to be sold to the ultimate consumer ' [14] This cessation of patronage not only includes all union members but is often extended to embrace people not directly affiliated with organized labor The two major labor federations potentially control the purchasing power of millions of consumers If the buying habits of this group could effectively be controlled and if the commodity boycotted was one which the group customarily consumed these organizations would have a weapon of tremendous power Unions are aware that production means not merely the manufacturing of goods but the creation of profits and unless commodities are removed from markets production is purposeless [15] At times the pressure is intensified by extending the boycott—secondary boycott—to those employers who enter into commercial relationship with the offending concern By means of this instrument of compulsion the union hopes to force the employer to concede its demands

Besides attempting to limit the sale of commodities the union uses the boycott to indicate its organized disapproval of certain implements and materials with which its members are called upon to work The boycott on materials permits the union to bring pressure upon an offending company indirectly conditions may be such that it is not possible to fight

[13] A combination of workmen to cease all dealings with another an employer or at times a fellow worker and usually to induce or coerce third parties to cease such dealings the purpose being to persuade or force such others to comply with some demand or to punish him for non compliance in the past —H W Laidler *Boycotts and the Labor Struggle* (John Lane Co New York 1914) p 60

[14] L Wolman *The Boycott in American Trade Unions* (The Johns Hopkins Press Baltimore 1915) p 13

[15] An illustration of the use of the boycott is the case of the attempted unionization of D E Loewe and Company of Danbury Connecticut Coupled with the strike the union proceeded to institute a secondary boycott The effect of this is demonstrated by some figures during 1901 the firm made a net profit of $27 000 which became a net loss of $17 000 in 1902 after the boycott began and a loss of $15 000 in 1903 The company concluded the net damages caused by the boycott amounted to $88 000

the *employer* directly as for example in the case of goods manufactured in prisons or ununionized shops Organized labor however by refusing to produce goods the raw materials of which were made under conditions injurious to unionism can adversely affect the demand for these materials This type of boycott is implemented by the ability of the union to withdraw the labor force if the employer should persist in his use of the boycotted materials

To effectuate a boycott the union must make known the goods of which it disapproves Although the law now prevents its use at one time the unions published an Unfair list This constituted Labor s Index Expurgatorius Herein were enumerated those companies which produced goods under conditions prejudicial to the labor movement Thus unionists and their sympathizers were informed as to the commodities to be boycotted Today the techniques used are the We patronize lists ' and the Union label " The former lists indicate the companies whose policies are approved by unions the latter is a trade marked label attached to goods produced under union conditions of employment Thus the consumer by seeking out those commodities which bear the stamp of union approval can boycott those companies which fail to receive the sanction of the labor movement

The legal status of the boycott has been the subject of two historic cases argued before the Supreme Court The first of these was the Danbury Hatters case[16] The employees of the D E Loewe Company members of the United Hatters of North America endeavored to force a closed shop upon the company by instituting a boycott against it The union, by both spoken and written word appealed to all whom it could reach to desist from purchasing the products of the offending company The company brought suit, under the Sherman Anti trust Act, against the union and its individual members, claiming that they as a result of their action constituted a combination in restraint of trade an act prohibited by the legislation The Supreme Court sustained the claim of the company and held both the union and its members individually liable to trip damages as provided in the Statute This decision established the precedent that a union conducting a boycott against the goods of a company engaged in interstate commerce was acting as a combination in restraint of trade and as such punishable under the law

The passage in 1914 of the Clayton Act was thought by labor to free it from the proscriptions laid down in the Sherman Act So assured was labor of the beneficial effects of this legislation that it hailed the Act as its Magna Charta This confidence rested upon that section of the law which states that The labor of a human being is not a commodity or article of commerce Nothing contained in the anti trust laws shall be con

[16] Lawl r vs Loewe 235 U S 522 (1915)

strued to forbid the existence or operation of labor organizations nor shall such organizations or the members thereof be held or construed to be held illegal combinations or conspiracies in restraint of trade under the anti trust laws

Subsequent to this enactment the Supreme Court sat upon a case involving a request by the Duplex Printing Press Company for an injunction against the International Association of Machinists restraining the union from proceeding with the boycott it had instituted against the products of the petitioning company The case came before the Supreme Court after the petition had been denied by the United States District Court and the United States Circuit Court on the grounds that the Clayton Act permitted such boycotts The Supreme Court[17] however reversed the lower courts by holding the Machinists boycott an illegal exercise of power The Court maintained that the union had resorted to coercion to secure the compliance of third parties with its boycott, and coercion upon third parties constituted an illegal act The Court in proceeding with its decision interpreted the phraseology of the Clayton Act to mean that the restrictions placed upon the use of the injunction were limited to those disputes engaged in by an employer and his own employees

Although, today the legal status of the boycott is somewhat uncertain generally speaking the courts tend to follow this course labor can patronize or refuse to patronize whomever it chooses If a primary boycott is instituted and the union relies upon peaceful persuasion the courts ordinarily sanction the action If coercion is resorted to the boycott then becomes illegal The secondary boycott since it entails the coercion of a third party, is held in most states to be illegal

The effectiveness of the boycott depends upon the ability of the union to deny the offending producer a market for his goods If the goods should be of the type customarily purchased by laborers or their sympathizers the union is in a favorable position to enforce its interdict On the contrary, if they should be the kind which do not ordinarily enter into the budgets of workers, the boycott may be ineffective To the extent that the law circumscribes the area in which the boycott can be used and to the extent that peaceful persuasion is insufficient to overcome the buyer's proclivity to purchase in the cheapest market the boycott diminishes in usefulness The boycott is powerful potentially but its potentialities can be realized only as more effective means are developed to extend its acceptance to an ever widening group of purchasers

Conciliation, Mediation and Arbitration

Industrial strife is costly The losses entailed are not restricted to those who directly participate in the struggle but are also borne by the

[17] Duplex Printing Press Company vs Deering, 254 U.S 443 (1921)

general public These losses however are not a sufficient deterrent to prevent the occurrence of strikes if it is believed that the ultimate gains to the victor will more than compensate for the losses temporarily experienced The desire to minimize or if possible to eliminate these losses has sent men seeking for more amicable methods of settling these differences between employers and employees

Conciliation is the method through which an amicable settlement of differences is arrived at by means of the voluntary getting together of the employer and his employees or their representatives, without the aid, intervention or compulsion of any outside agency

Conciliation, if it is to operate successfully requires the existence of labor organizations and the acceptance of the technique of direct negotiation As the employer and his employees become more and more accustomed to settling differences through negotiation the chances of conciliation working to the mutual advantage of each increases The granting of concessions ceases to be interpreted as an admission of weakness and is accepted as a necessary concomitant of conciliation As unions grow older as the employers shed their original distrust of labor organizations, conciliation becomes more common

Conciliation has the greatest opportunity for success when the issue under consideration concerns the interpretation of some specific section of an already existing agreement If fundamentals have been agreed upon —such as the recognition of the union—compromise can generally settle disputed details However if an impasse should be reached, and either party becomes convinced that an amicable settlement can only be achieved at the cost of some vital concession the negotiations will break down and the matter at issue will be decided by force

Mediation is a technique devised for the purpose of amicably settling industrial disputes through the use of the good offices of a third person The mediator does not sit in judgment he has no authority to render decisions He is ordinarily some prominent person in whom the disputants have confidence who through the prestige of his position or knowledge endeavors by persuasion to induce the contestants to reach an agreement so that strife can be avoided

The mediator must be Job like and possess a high degree of diplomatic skill His is the delicate task of securing concessions from men who already have declared their unwillingness to make concessions The mediator must without embarrassment to either the employer or the employee, ascertain through suggestion the concessions which they are really willing to make If he be tactful, he may succeed in settling the issues to the satisfaction of all concerned

The Federal government has established several mediation agencies The Erdman Act (1898) and its amendment the Newlands Act (1913), made it the duty of certain government officials to act as mediators in

railway disputes Today this obligation is lodged in the National Railroad Adjustment Board and the National Mediation Board (1934) Today the National Labor Relations Board although not obligated to is granted permission to use its offices in mediation Between April 1935 and July 1937 the Board succeeded in amicably settling some 6000 labor disputes

Voluntary arbitration is a method of settling differences between disputants by submitting the respective cases to an impartial party or board which, after examining the claims of the contestants renders a verdict Since the verdict is not enforceable at law it is not mandatory upon the contestants to abide by it However, since voluntary arbitration could not have occurred in the first instance had it not been sanctioned by the disputants the probabilities favor the acceptance of the results

Both employers and unions have hesitated on occasions to accept voluntary arbitration through fear that the ultimate verdict would be unsatisfactory Neither the employer nor the union may feel that the issue at stake is one that can be settled satisfactorily through compromise yet they know that compromise is of the very essence of voluntary arbitration The matter may be of too vital concern to hazard the risk of loss through arbitration Even though voluntary arbitration is a very useful device, particularly when the interpretation of sections of existing trade agreements is in dispute it is no perfect guarantee against strikes and lockouts

Compulsory arbitration makes it mandatory upon both parties to a labor dispute to submit their respective claims to a court of arbitration and to abide by its verdict Failure to comply with the law on either score makes the offender liable to fine or such other punishment as may be provided

Compulsory arbitration has been attempted in only one state—Kansas—although it has long been used in Australia and New Zealand In 1920 Kansas established an Industrial Relations Court which had jurisdiction in the fields of public utilities, mining manufacturing of food products and manufacturing of clothing The court after operating for some 3 years was declared unconstitutional by the Supreme Court on two points it exceeded its constitutional rights when it fixed wages in competitive industries and compulsory arbitration could not constitutionally be extended beyond public utilities industries [18]

Compulsory arbitration appeals strongly to many people Impressed by the losses engendered by strikes, distraught by the violence which has on occasions marked industrial disputes they hail compulsory arbitration Objections are raised against compulsory arbitration however The determination of wages and hours is removed from the sphere of competition Rather than the impersonal forces of the market determining the recompense of workers it becomes a question of fairness decided by a

18 Wolff Packing Company vs Court of Industrial Relations 262 U S 522 (1923) 267 U S (1925)

tribunal Authoritative control is seen as encroaching upon the domain of free decisions Labor however is the chief critic of compulsory arbitration Labor maintains that compulsory arbitration denies it the most effective pressure weapon it possesses—the strike Stripped of this instrument it stands impotent before the arbitration court a court whose personnel may not always be sympathetic to the aims of organized labor

One technique which is widely endorsed is *compulsory investigation* This system makes it illegal for workers to strike, or employers to institute lockouts until the state board has had the opportunity of investigating the disputed issues and of publicizing its findings If at the expiration of the compulsory waiting period the disputants wish, they can then carry the dispute into open conflict

This method has been used in Canada with gratifying results The board does not move until the decision to strike has been reached then acting as a court, it proceeds to investigate During the course of the investigation it is always ready to act as a mediation board During the course of the investigation strikes and lockouts are illegal Although this system has not completely eliminated strikes from Canada it has greatly reduced their frequency the investigation by bringing to light obscure issues creates an atmosphere of understanding conducive to conciliation and mediation

One argument in support of compulsory investigation is that which emphasizes the right of the public to be informed concerning the issues in dispute If the public is to be inconvenienced they should have some knowledge concerning the validity of the contestants claims Public opinion may be a potent force in securing an amicable and just settlement of the dispute One objection raised by unions is that the compulsory waiting period decreases the effectiveness of the strike by denying the union the opportunity of striking at the most advantageous time In short the union fears that this system interferes with timing a factor which often determines success or failure in a labor dispute

Conclusion

Fundamentally the effectiveness of a union in collective bargaining depends upon the pressure weapons it can develop Competent representation in collective bargaining is most necessary, but even competent representation is insufficient unless behind it lies a threat to the employer s profits Therefore the principal handicap to a peaceful solution of labor disputes is the fear on the part of the union that the techniques suggested will involve a surrender of its pressure weapons

READING LIST

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ALEXANDER F, and HEALY W *Roots of Crime* (Alfred A Knopf New York 1935) An etiological study of crime from the standpoint of psychoanalysis including illustrative case studies

BARNES H E *The Story of Punishment* (Stratford Company Boston 1930) A concise history of punishment for crime leading to the statement of a more humane rational and scientific approach to the crime problem

BARNES, H E *Society in Transition* (Prentice Hall, Inc New York 1940) The essential facts of crime in contemporary America especially organized crime and racketeering are described in terms of the realities of to day

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COOPER C R *Here s to Crime* (Little Brown and Company, Boston 1937) A realistic statement of the relations of politics and civic corruption to racketeering

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GLUECK S and E (Eds) *Preventing Crime* (McGraw Hill Book Company, New York 1936) A symposium describing various promising and representative crime prevention experiments in the United States

HAYNES, F E *The American Prison System* (McGraw Hill Book Company, New York 1939) A description of existing penal institutions The author

feels that probation parole prison farms and camps are leading to the abolition of the old prison system

HEALY, W, and BRONNER A F *New Light on Delinquency and Its Treatment* (Yale University Press New Haven 1936) A significant book the emphasis is upon family life of delinquents and a comparison of delinquent and non delinquent children in the same family

LAROE W JR *Parole With Honor* (Princeton University Press Princeton 1939) Practical experience as a member of a board of parole enables the author to refute mistaken ideas concerning parole as a form of leniency and to show that parole when honestly administered affords the best way of releasing prisoners

NELSON V F *Prison Days and Nights* (Little Brown and Company Boston 1933) A vivid account of prison life by an intelligent and articulate ex prisoner

RECKLESS W C *Criminal Behavior* (McGraw Hill Book Company New York 1940) Considers the variations of criminal behavior and the methods used to combat it

SHAW C R *The Jack Roller* (University of Chicago Press Chicago 1930) *The Natural History of a Delinquent* (University of Chicago Press Chicago 1931) *Brothers in Crime* (University of Chicago Press, Chicago 1938) Each is a detailed case study showing the influences producing crime and the methods used in analysis and treatment

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TANNENBAUM F *Crime and the Community* (Ginn and Company New York 1938) An illuminating textbook which attacks former partial theories of crime and presents a constructive treatment of crime as a function of society

WHITE W A *Crimes and Criminals* (Farrar and Rinehart New York 1933) An eminent psychiatrist claims that the formulas of yesterday must be discarded in favor of the advances made by modern science in the understanding of human conduct

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BEARD C A, *American Government and Politics* (The Macmillan Company, New York, 8th edition, 1939) A clear readable text on state and national government, often provocative seldom pedantic

BRUCE H R *American Parties and Politics* (Henry Holt and Company, New York 3rd edition 1937) A useful text on the mechanics of political organization and procedures

CORWIN E S, *The President* (New York University Press, New York 1940) Historical and analytical approach to the power of the President under the Constitution which, while legalistic, many will find as stimulating as

his earlier studies of the Supreme Court *The Doctrine of Judicial Review* (1914) and *The Twilight of the Supreme Court* (1934)

CUSHMAN R E, *Leading Constitutional Decisions* (F S Crofts and Company New York, 7th edition, 1940) The best small volume of outstanding decisions of the Supreme Court enriched by Cushman s valuable comments on each case and topic

DIMOCK M E *Modern Politics and Administration* (American Book Company New York, 1937) Notable particularly for its functional approach and its emphasis upon the trend in public administration and administrative law

LASKI H J *The American Presidency* (Harper and Brothers, New York 1940) Keen appraisal of the relations of the President to his Cabinet, the Congress and the Supreme Court by a distinguished English scholar

LOGAN, E B, *The American Political Scene* (Harper and Brothers New York revised edition 1938) Eight vigorous articles by authorities on party politics

MCBAIN, H L, *The Living Constitution* (The Macmillan Company New York 1927) The most readable short discussion and interpretation of the Constitution of the United States

ODEGARD, P H, and HELMS E A, *American Politics A Study in Political Dynamics* (Harper and Brothers New York 1938) Alive in style and material showing political parties pressure groups bosses and machines in motion

OGG F A, and RAY, P O *Introduction to American Government* (D Appleton Century Company, Inc, New York 6th edition, 1938) An outstanding standard text, rich in details of government

ORTH S P, and CUSHMAN R E, *American National Government* (F S Crofts and Company, New York, 1935) A splendidly full treatment of the branches of the national government for those particularly interested in constitutional issues

RANKIN R S, *Readings in American Government* (D Appleton Century Company Inc New York 1939) The best single volume collection of readings on phases and organization of local state and national government

SAIT E M *American Parties and Elections* (D Appleton Century Company Inc New York revised edition 1939) Indispensable as a reference work and exhaustive in material for class use

WHITE L D *Introduction to the Study of Public Administration* (The Macmillan Company New York, revised edition 1939) Clear full treatment by an outstanding authority in a rapidly growing field of study and activity

WILLIS H E *The Constitution of the United States at the End of One Hundred Fifty Years* (Indiana University Publications Social Science Series No 1, Bloomington Ind 1939) A valuable reference pamphlet citing major decisions of the Supreme Court which have interpreted various phases and clauses of the Constitution

YOUNG J S MANNING J W and ARNOLD J I *Government of the American People* (D C Heath and Company New York 1940) An integrated

presentation of the political, economic and social functions of American government—federal, state and local including many topics not discussed in the conventional texts in political science, such as regulation and promotion of vocations recreation the school the family and crime

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Chafee Z Jr *Freedom of Speech* (Harcourt Brace and Company New York, 1920) A study of legal restrictions on civil liberty in time of war

Doob L W, *Propaganda* (Henry Holt and Company New York 1935) An analysis of the nature of propaganda by a psychologist

Gruening E H *The Public Pays* (Vanguard Press, New York, 1931) An account of the Federal Trade Commission's investigation of the activities of the electric power industry as a pressure group

Herring, E P, *Group Representation Before Congress* (Johns Hopkins Press Baltimore 1929) A study of the way pressure groups try to influence Congress

Lasswell H D, *Politics* (McGraw Hill Book Company, New York 1936) A general statement about government in the terms of the things people want from government

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Odegard P H, *Pressure Politics* (Columbia University Press, New York, 1928) A study of one pressure group—the Anti Saloon League

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Riegel O W, *Mobilizing for Chaos* (Yale University Press New Haven 1934) An explanation of the control of information by the State in the interests of nationalism

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